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VARIOUS SMALL BUSINESS CAPITAL FORMATION PROPOSALS AND THEIR JOB CREATION POTENTIAL

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BEFORE THE

SUBCOMMITTEE ON URBAN AND RURAL ECONOMIC DEVELOPMENT

OF THE

COMMITTEE ON SMALL BUSINESS UNITED STATES SENATE

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FIRST SESSION

ON

VARIOUS SMALL BUSINESS CAPITAL FORMATION PROPOSALS AND THEIR JOB CREATION POTENTIAL

JULY 13, 1983

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VARIOUS SMALL BUSINESS CAPITAL FORMATION PROPOSALS AND THEIR JOB CREATION POTENTIAL

WEDNESDAY, JULY 13, 1983

U.S. SENATE,
SUBCOMMITTEE ON URBAN
AND RURAL ECONOMIC DEVELOPMENT,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met at 10:15 a.m., in room SR432, Russell Senate Office Building, Hon. Alfonse M. D'Amato, presiding.

Present: Senators D'Amato and Sasser.

Staff present: Steve Grabenstein, legal assistant to Senator Sasser; Steve Williams, counsel; Bruce Ray, legal director for Senator D'Amato; and Dorothy C. Olson, hearing clerk.

Senator D'AMATO. The Subcommittee on Urban and Rural Economic Development will come to order.

Today we have a number of distinguished witnesses, and will take up a number of bills that have been proposed by some of my colleagues and myself.

STATEMENT OF HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK AND CHAIRMAN OF THE SUBCOMMITTEE ON URBAN AND RURAL ECONOMIC DEVELOPMENT

Senator D'AMATO. I have a brief statement, and then we will get into the witnesses.

What are the most efficient and effective means of stimulating increased employment? This is a question that has confronted policymakers for decades. In the 1960's and the 1970's the notion of massive Government spending on make-work programs was deemed the best means of reducing unemployment. These programs were usually timed to coincide with periods of recession. Might I add, also, oftentimes before elections. Unfortunately, there is a significant lag time involved before the effectiveness of a jobs program occurs. As a result the benefits derived from make-work programs are usually not felt until a recession is over. By that time, the only impact is a negative one on the deficit and inflation.

The economic times today could be potentially the most exciting and perplexing in the postwar period. Our Nation has recently endured the deepest recession since the Great Depression of the 1930's. However, we are now entering a period, hopefully, of sustained economic growth without rampant inflation. The recovery is

broad-based, with all segments of the economy participating. I am sanguine about the future, however, and I think that much depends on the world economy.

Despite the economic recovery, unemployment is improving only gradually. The goal of many policymakers is to expedite the employment gains that will follow sustained economic growth. I share this concern. However, I question some of the methods used or advocated by some to solve the unemployment dilemma.

I do not subscribe to the laissez-faire philosophy that jobs will naturally become more abundant over time. This I consider to be an irresponsible approach to the problem. On the other hand, multibillion-dollar jobs programs which only temporarily improve employment and will not result in long-term economic growth. The ensuing deficits will, of course, create future unemployment. Thus, for those who espouse this approach, I counsel patience. There is a much more constructive path to follow.

The purpose of this hearing is to examine the role of capital formation and what it does in terms of job creation. I believe that increased capital formation is the avenue that must be explored in improving the lot of the unemployed. As a policymaker, it is my purpose to help create incentives for employers to expand their production and to hire more workers.

We have before us today three pieces of legislation addressing capital formation and job creation. It is my hope that this hearing will build a record in support of job creation through improved investment.

Of course, the President also favors increased levels of capital formation as a solution to the unemployment problem. In many ways, the centerpiece of the administration's economic policy is encouraging capital formation, rather than consumption, by both individuals and corporations. The President is correct in assuming that if the Nation is to compete abroad, increasing the savings rate is critical. It has also become evident from the past recession that individual and corporate health is linked to the amount of savings accumulated. Those entities that placed a premium on leverage perished as interest rates rose and sales declined. This has had a decided effect on employment.

Tax incentives to improve capital formation may have a short-term negative impact on the deficit. However, I believe that the way to reduce the burden of the Federal deficit in the long run is to broaden the tax base by putting people to work through encouraging capital formation and savings.

The small business sector can play a vital role in this process. To improve employment, we must concentrate our efforts on small business. Over 99 percent of the more than 4.9 million business establishments in the United States today employ fewer than 500 people. More than three out of every four workers are employed by small enterprises.

However, last year was a difficult one for the small business community. In 1982, approximately 99 percent of all bankruptcies filed were by small firms. In absolute figures, small business bankruptcies increased by 38 percent from the previous year.

My point is that, while the small business sector is critical to future employment gains, it has suffered tremendously in this past

business cycle. The health of the Nation depends a great deal on the strength of small business establishments. It is this segment of our economy that has the most difficult time acquiring the necessary financial and physical resources to remain economically viable.

In short, capital formation through tax incentives will help firms expand production. This leads to reduced unemployment and to an expanded tax base—to additional employment. These are the goals which we must make a reality for the economy to prosper and for the small business community to flourish.

The first witness today is Mr. Arthur Levitt, chairman of the board of the American Stock Exchange. Mr. Levitt.

STATEMENT OF HON. ARTHUR LEVITT, JR., CHAIRMAN OF THE BOARD, AMERICAN STOCK EXCHANGE

Mr. LEVITT. Thank you, Mr. Chairman. I am honored to participate at these important hearings. And during these sessions your committee will be asked to weigh the relative merits of tax and other incentives for small business, versus the potential loss of revenues to the Government. You are going to be reminded of a good deal of research—some growing out of the last White House Conference on Small Business, and some generated by your own extremely able staff.

You will also, of course, be considering specific legislative proposals, and I would like to take a moment to comment on them.

But in considering my testimony today, I felt that perhaps a greater value as a lead-off witness might be to move a little bit beyond the facts and figures. With your permission, I would like to briefly describe—based on my own experience—part of the impact of small business on our people, our Nation and on the major problems facing the United States.

To start with, I would like to focus on some people who once worked at the American Stock Exchange. Like so many small business people throughout America, they were good people, restless people, people who believed in the American dream of taking risks and of starting their own businesses. They didn't much care about what the rate of interest was, what the rate of inflation might be, what the odds against them were said to be. They were determined to start their own business in the face of any kind of obstacle that might come up. They were so totally tenacious and dedicated to that purpose that, despite those odds, they managed to make it.

For much of last year, the American Stock Exchange, like many organizations during that very difficult time, only hired to replace key departing people. But at the same time, there were those who worked at the exchange who were creating jobs, although we didn't think about it in those terms at the time. And I am referring now to people who left the exchange, who struck out on their own to become their own bosses. Remember, every time a person left and started a new business, he or she was replaced. So immediately that move created at least one new person working in our economy.

Often the person leaving would start in business with their husband or wife, and another job was added to the total.

Some of the people who left obviously moved into areas that were a direct extension of their exchange jobs. One of our financial analysts set up a CPA firm. Another offered an investment advisory service geared specifically to individuals. Three individuals in our press relations area left separately to establish public relations firms.

But what surprised me when I started to track down some of these cases for testimony this morning, was really how far afield some of these employees went. One woman, in our personnel department, left town with her husband and established a wholesale/retail fish operation out on Long Island. The other day when I asked how they were doing, I was told that their very small operation was very successful, and that they were employing three or four young people part time.

Now, that may not seem like a major point for these Senate hearings. But I would note that during the long months of the recession, that young couple was doing more to solve a difficult national employment problem than many very large companies with multimillion-dollar budgets.

Another of our ex-employees left to set up a men's haberdashery shop. And it proved so successful that during a recent visit to Florida he set up another shop and is planning several more in different parts of the country.

Several employees left to open restaurants, one of the growth industries of our day. And one left to begin a personal computer outlet, and I am pleased to say he really caught on to a boom that is sweeping the country. Another, interestingly enough, opened a roller skating rink.

I can't give you complete figures because our personnel records really didn't focus on this aspect of what happened to our people, being mostly concerned with whether conditions were satisfactory on the Amex job and whether we were losing people for competitive salary reasons.

But I am pleased to say that our conditions are good. And we intend to keep our best people. But even these few examples—and there are others—illustrate the dynamics of job creation by small business.

First, the person leaving, then those who hire, cashiers, sales people, waiters and waitresses, drivers, stockroom help, repair people. And add to that job creation in suppliers, furnishings, and construction of new facilities.

These were recent examples, but I can't resist going back to 1967, to a 24-year-old economist with the American Stock Exchange who left to establish a new magazine called Institutional Investor. You probably all read last year how this entrepreneur, named Gil Kaplan, now the head of a multimillion-dollar enterprise, fulfilled a lifetime dream by conducting a Mahler symphony at New York's Avery Fisher Hall. So, for at least one performance, a full symphony orchestra found employment.

And I might say to you that this remarkable entrepreneur is considering a career departure which could involve him even more extensively in terms of interests which were not central to the publishing industry.

Now, if you take this same process at work at the exchange and you move it around to other businesses, those involved in more technical activities, those whose employees would more likely be engineers or scientists, I can assure you that that same process is at work.

The Friday before last we gathered some of the securities industry's top analysts at the exchange for a seminar on telecommunication. On that platform were six companies listed on the exchange. None of the six had even been in existence 30 years ago. Two, in fact, were founded in the 1970's and three in the 1960's.

Now, they are established firms. The fact that they are trading on our exchange indicates that. And they provide several thousand jobs, they compete in overseas markets, they hold off foreign competitors in this country and contribute advanced technology to our industries.

I could go on and describe industry after industry represented on the American Stock Exchange. We talk about construction, about retailing, health care, energy, and so on. And I could point to the very same process. Now very well-established companies contributing jobs, products and service; companies that didn't exist, who were fledgling enterprises just a few years ago.

Now, I am not suggesting, of course, that everyone who sets out on this entrepreneurial path is going to make it. We all know the appalling record of bankruptcies in this recession. We all know that small business was hurt worse than any other element of the economy. I think we could prove that high interest rates and rates of inflation that are above average are punishing to small businesses, because they don't have the kind of resilience that larger businesses have. Their margin for error is far less great.

Even now that the recovery seems firmly under way, last week's figures from Dun and Bradstreet show that bankruptcies through the first half of 1982 were 27 percent above last year's record, which was the highest since the early 1930's.

Nor am I suggesting that if this committee does nothing that Americans will give up the dream of starting their own businesses. I mentioned before that they are willing to go against any odds, and I think that is going to continue. Their hope, their expectations, their faith, their confidence, their spirit, runs too deep.

Nor am I suggesting that if this committee does nothing Americans are going to give up on this. We know that last year 567,000 new businesses were started, which was the second-highest year on record, and just slightly below the 1981 alltime high. I can assure you from my own experience that every time a small business starts up it is a very personal, it is a very intense kind of experience. I know that when I began in business in the securities field barely 20 years ago, my partners and I had all too many moments in private meetings at one another's homes or at the office, in which we questioned the viability of our company, the predecessor of what is now known as Shearson/American Express. We asked whether we could make it. We started out with a firm that had four employees and a tiny office on Broad Street, and very little capital. And this question of success or failure was something that we lived with morning, day and night when others were telling us that we would do better to get out of the business.

In the years since we started that tiny little company, one of my original partners left to start a newspaper in Litchfield, Conn., called the Litchfield Times, a weekly newspaper, and I think one of the best in the country. A second one of my partners left the business to become a theatrical producer, and after a whole succession of flops, when a lot of people told him to get out of the business, today you find him as the producer of "Amadeus," "Sophisticated Ladies," and "Nine." That's a pretty good success record. A third heads Knoll International, one of the largest furniture companies in the world, and a company soon to be listed on the American Stock Exchange. I am, of course, here at the Exchange. Another partner remained with that firm as it grew to number thousands of employees here and abroad, and Sandy Weil is now president of American Express.

So each, in our own way, has contributed to the economy and to job creation.

I am not suggesting that we make the process of small business formation fail-proof. I don't think that is either possible or desirable. But I do urge that when you weigh the specific proposals before you that you consider all the contributions small business makes and all the obstacles it faces.

We are not looking for a handout. We are not looking for something for nothing. We are looking for an even field, a field in which we are free to succeed and free to fail, if that be the case.

A good rule of thumb is that whatever is difficult for business is really much, much harder for small business.

Today, a Japanese firm can afford to invest five times as much as its American counterpart in the same research and development project because the cost of capital is so much lower in Japan. That figure is for all business. As you know, the cost of capital is even higher for small business.

Is business burdened by a mound of paperwork and regulations? That mound is a mountain to small business.

Is business pressured by legal fees, and interest rates, and taxes? The pressure is genuine pain for smaller business.

Congress can ease that pain by enacting some of the small business legislation that has been introduced. For example, S. 1043, the small business Capital Formation Tax Act, which you, Senator, introduced, and which is cosponsored by Senator Weicker and nine other of your colleagues in the Senate.

Its provisions would address many of the key concerns of the last White House Conference which have yet to be enacted into law. It would facilitate the process by which small business can attract and retain vitally needed capital.

For example, as you know, section 7 of the act encourages a recycling of capital gains into other small businesses. Section 3 enables small business people who have spent 5 or more years in building their enterprises, to really enjoy and benefit from the fruits of their labor.

The other provisions of the act were also strongly supported by the last White House Conference, and I join in that support. They include provisions such as lowering the corporate tax rate and increasing the capital gains deduction for small business.

I understand the estimates are not complete on what the costs of these proposals would be or what might be the ultimate effect on the recent budget resolution. But I believe that the principles behind them are as strong now as when they were put forward by the Small Business Conference in 1980. And I would hope that the Congress and the President will see them as consistent with the long-range economic health of the Nation.

In addition, I would also urge favorably considering S. 842, the small business participating debenture bill, a bill which, incidentally, grew up as a result of the recommendations of a very large company, Arthur Anderson and Company, the accounting firm, which helped develop this proposal. As a recommendation—I think it was 1 of the top 10 recommendations at the White House Conference on Small Business. This would create a means for small business people to raise capital without sacrificing the key quality and strength of the entrepreneur. Equity ownership in his or her business.

Mr. Chairman, although I think these measures make sense in purely economic terms, I would also hope you would consider the spirit that they infuse into our national life.

As chairman of the last White House Conference on Small Business, I spent several years traveling around the country talking with small business people. In addition, as chairman of the American Stock Exchange, I am continually meeting with medium and larger businesses, speaking on college campuses, and meeting with civic leaders and people in other professions.

What I find very encouraging and very exciting is that entrepreneurship has recaptured the American imagination. I really feel there is a bias in this country against bigness, whether it is big government, big business, or big labor. But matching that is an absolute passion, a fervor, an absolute feeling on behalf of growth in entrepreneurship creativity, a kind of pioneer spirit that is part of America. At business schools the deans are telling me that classes which deal with entrepreneurship, growth companies, and small business are packed to capacity. And surprisingly, even when I go to liberal arts schools and talk to them, I get the same question: "What do I have to do, Mr. Levitt, to start a small business? How can I do it? Am I better off doing that than getting a job with some large company? How can I avoid getting into the rat race, the kind of rut that is involved in just joining some large company and being an unknown quantity."

There was a recent study where Prof. Karl Vesper at the University of Washington writes of an unorganized and invisible constituency for entrepreneurship, for the startup of enterprises.

My experience around the country in recent years supports that view. I am absolutely convinced that in addition to the figures we have seen on thousands of new businesses starting each year, you have to take into account this vast, invisible constituency of Americans. Women, whose husbands are working; husbands, whose wives are now in the work force and are now better able to take economic risks, and with them an unnumbered multitude who are gathering their savings, weighing the risks, awaiting the opportunity to become entrepreneurs—minorities, majorities, people from all walks of life.

This underground constituency can provide a huge army of support for the measures that you, Senator, support, that will aid existing small businesses and encourage new ones. The big stumbling block is capital. Whatever this committee can do to encourage access to and retention of capital for small business will be repaid in the flowering of economic vitality throughout our society.

I am asked nearly every day, by the press, by academics, by business people, are we coming out of this recession? Is it real? My answer to that is that we probably are coming out of the recession. As to whether it is real it will depend upon a lot of factors, not the least of which, in my judgment, is job creation. That's the name of the game.

You have, in my judgment, wisely addressed yourself to that issue, which is the bottom line of this whole program. It is creating jobs in America, and small business can do it better than anybody else.

I thank you for your efforts, and wish you every success in pursuing this program.

Senator D'AMATO. Mr. Levitt, we thank you, not only for being here, but for your participation in the past Presidential Conferences on Small Business.

And, by the way, I would hope that we could have another conference. I think it is important. And if there were to be another conference, in your opinion, would capital formation again rank as one of the prime—or the prime consideration for the small business community?

Mr. LEVITT. Yes. I think that the two prime areas for consideration of a second conference are the ones that are still the most burdensome for small business: Capital formation and Government regulation. The key question here is that small businesses simply can't afford to protect themselves against the kind of all-encompassing regulation which applies equally to large and small businesses. So those two issues would be paramount.

Senator D'AMATO. In your opinion--and I recognize that this might be difficult—were S. 1043 to have been in place, do you think that that would have reduced the wave of bankruptcies and failures that were experienced during this past period of economic recession?

Mr. LEVITT. I think that were 1043 to be in place it would have provided both an additional vehicle that doesn't exist today, as well as create incentives for capital that even go beyond 1043 itself, in that it would be a signal to the country that the Congress, the administration, the leadership of the country, is mindful of the needs of small business. Psychology is so critical to small business financing, where the money doesn't come just from banks and pension funds and investment bankers; it comes from relatives, from uncles and aunts. And that feeling, that psychological lift, would be terribly important. So I would answer in the affirmative to your question.

Senator D'AMATO. Let me ask you, how do we keep a vibrant economic recovery moving forward, and yet still restrain the fires of inflation?

Mr. LEVITT. I think you have to do, in my opinion, several things. I think as hard as it may be, you must reduce those budget deficits.

They represent the most serious threat to the recovery that I can think of. The markets up to now have been saying that the Congress and the administration will get their act together and bring about a reduction in deficits. If that doesn't occur, if, the closer we get to an election paralyzes the administration and the Congress, I think the markets will begin to tell a very different story. And that is going to hurt small as well as big business.

I think the way that we can address this is not only by thinking about how to reduce the deficits, but also by creating incentives for those entities which can create jobs. And you are right on the cutting edge of programs that may initially look like they may cost something, but I think if you balance the benefit in terms of additional jobs and the creation of additional enterprises, this isn't a cost; it is a net addition to revenues for the Government.

Senator D'AMATO. Maybe we could touch on one other area, and I certainly thank you for going beyond the scope of just those legislative proposals that are before the committee today. I would ask for the record if you would favor the reduction of the capital gains holding period? That is from a year to 6 months, No. 1. And second, why? And third, what economic benefits would you see taking place as a result of reducing the holding period?

Mr. LEVITT. I would favor the reduction. The last time—well, I would liken it to what occurred in 1978 when the Steiger amendment was passed reducing the capital gains tax. It had a very beneficial effect in terms of stimulating an interest in capital formation. And in a period of time when new underwritings were virtually nonexistent, the pickup in the year following that reduction in the capital gains tax was nearly eight times the year before.

I believe that by reducing the holding period for capital gains, the liquidity of our markets will be enhanced, whereby individual investors who are holding securities for relatively noneconomic reasons, merely to avoid taxation prior to the 12-month period, would feel freer to exchange securities for other securities. And the liquidity that would be added to the markets would make the markets more readily available for additional financings.

I think, in addition to that, the kinds of companies that seek public financing or even private financing from individuals who are motivated by tax considerations, would find an additional motivation when you remove those tax considerations. I think anything which distorts the flow of capital, depending upon what the tax benefit would be, creates a distorting effect, and that hurts the market. I think to the extent to which tax considerations are removed the market becomes more liquid, you bring more people into that market, more financings are possible, more dollars are available. I think it is critically important that those dollars become available to create the jobs we were just talking about.

Senator D'AMATO. I know that is a little aside from this bill, but I think it is part and parcel, and somehow we in the Congress lack the capacity to go forward. Most of the people that you speak to will indicate that they feel that this will be a revenue enhancer, produce more economic investment and turnaround, as you have indicated; probably reduce the deficit by $3 to $4 billion, and not cost money. But somehow, we are so afraid to be caught in the bind

of seeming to advocate tax breaks for the business community and for investors, et cetera. And it really doesn't do that.

Mr. LEVITT. It really doesn't do that, and I think it is simplistic to say that it is a benefit for the rich paid for by the poor. I think that the labor unions in America and the average worker in America who has invested in pension funds, have a vital interest in reducing the holding period. Because if I am correct and our markets would react favorably—and I expect they would to a reduction in the holding period—the billions of dollars invested in pension funds in equities would benefit as well. So I think it is an issue for all Americans.

Capital formation is something that the smallest business person, the average pensioner, the teacher, anyone in America who has to fight the ravages of inflation by having a pension that would tend to respond affirmatively to that, has a critical interest in this.

Senator D'AMATO. I thank you so very much for your participation.

Mr. LEVITT. Thank you.

Senator D'AMATO. The Honorable William J. Donohue, Chairman of the State Department of Commerce. Mr. Donohue.

STATEMENT OF HON. WILLIAM J. DONOHUE, CHAIRMAN, STATE DEPARTMENT OF COMMERCE, ALBANY, N.Y.

Mr. DONOHUE. Good morning, Senator. I want to thank you for providing me with this opportunity to express my support for the Small Business Capital Formation Tax Act and to discuss other issues vital to small business development in New York State.

I am going to skip over much of the prepared statement. It essentially is information that you are readily acquainted with on small business formation in the United States. I will skip to the importance of small business in New York State, and then make just a few comments and hopefully get into a very brief discussion with you.

The State department of commerce includes a division for small business development. New York State has more than 400,000 small businesses. They account for 98 percent of all business establishments in the State, and 49 percent of all private sector employment.

In the growing high technology manufacturing sector, small businesses make up 81 percent of all such firms in our State. We are working to enhance the advancement of these firms, and the development of new small ventures through several programs, primarily through our Corporation for Innovation Development, a subsidiary of the State Science and Technology Foundation, of which I am the statutory chairman.

A CID revolving fund, made up of matching $1 million grants from Federal EDA and New York State is used to make high-risk startup capital available to new ventures. Thus far, the CID program has financed six new businesses with equity valued at $705,000.

The State department of commerce also includes a division for small business development and a Division for Minority Business Development. Each of these units has a mandate to advocate poli-

cies and offer programs designed to spur expansion of existing small businesses and to assist new business development. They work with other economic development divisions to target specific programs such as our high-tech made in New York program, which promotes high-tech products in overseas trade shows. We work particularly with the Federal SBIR program, and Federal and State procurement programs. Mainly the department works in such a manner as to provide technical assistance to small businesses, and assist them to get into the mainstream of American business life; particularly to contract with the Government and with major private sector employers.

New York State's resources are limited. There is little we can accomplish in building large pools of new capital for small business investment. The present structure of Federal business taxes and investment regulations, the nature of our capital markets, combine to deny ready capital to small and new businesses. This is nothing new, particularly for equity and long-term debt, even where there are strong potentially profitable investments. Large banks, insurance companies and other financing institutions are not closed to small companies. It is simply economically inefficient, in their eyes, to consider investment in many instances in such companies.

The proposed S. 1043 amendment includes several important provisions which could be very effective in focusing capital investment on profitable and potentially profitable small businesses.

The proposed revisions to the Federal corporate tax rate structure will provide direct, straightforward help by increasing retained earnings and generating the additional revenue necessary for investment in expanded facilities and employment. So I heartily recommend that you go forward with that amendment.

The three incentives designed to attract more equity capital to small businesses would make such investments more profitable, and thus more attractive to those persons and institutions managing venture capital and investment funds.

Finally, significant savings in operational costs will be possible for those small firms eligible to use the cash receipts accounting methods under your bill.

In summary, this bill contains direct incentives for small businesses to attract investment, to increase earnings, to expand successful operations, to hire new people and to continue and extend the vital contribution that they make to economic recovery in New York State and throughout the Nation.

I would like to comment briefly on the other bills before you today. S. 842 could prove to be of special importance. The small business participating debenture, if it proves attractive to the investment community—and I believe that it will—could provide a new market for small business investment that has never existed before.

As Mr. Levitt pointed out, it is especially important to small businessmen that they be allowed to maintain the ownership of their own corporations, given the motivation that goes with ownership. That is exactly what that amendment would most likely do. There is minimal experience in New York State with hybrid securities such as this, but I would assume if this idea takes off it will

take off first in New York and New York City's investment market. And you can bet we will use it to our best advantage.

Section 371, as Senator Sasser has pointed out, provides an enhanced jobs tax credit for labor intensive small companies. Again, in this instance, we have an incentive which provides a direct economic signal to its constituency. We think it would be particularly important in employing those who are structurally unemployed and those who are least likely to be employed.

And I would Senator, like to make a couple of other comments that are not contained in my written material.

First of all, I want to congratulate you and your staff. I have worked with Bruce Ray in the past and I know of his capability.

I think what you and the other Senators and the Congressmen who co-authored these bills—is to distinguish those behaviors in small businessmen and in the investment community which are desirable from a public sector point of view, and which must be rewarded if we are to bring those behaviors forth.

I suggest that that is one of the major works of your Small Business Committee, to define precisely those behaviors which the public sector would like to bring forth and, if you will, enhance, in our State and in our Nation.

I believe that the provisions of these bills go a long way to defining exactly those behaviors and to rewarding them. So I think that we can predict that they will be successful, because these are highly targeted incentives.

I also note that they are very simple. They appear to be fairly simple, both to the businessman and to his accountant, and fairly simple to administer from the Federal point of view. It may be also fairly straight forward for States to latch on to and to create some kind of a supplementary incentive.

I would suggest also, Senator, however, that no matter what tax program we come up with, there will always be a need for capital, the availability of public sector capital for small business development. Perhaps less of it, however, as these tax programs and others that the Federal Government has already created, really take effect.

I see the capital markets growing in strength. There is a lot more capital available to businesses—mostly to large businesses, but to all businesses—than there was just 5 or 6 years ago, because of TEFRA and more recent changes in the Tax Act.

I suggest to you that we will always need the industrial revenue bond; we will always need the Small Business Agency programs. And I want to congratulate you for the tough stance that you have taken on the industrial revenue bond program, and encourage you in the face of what appears to be another effort to curb the industrial revenue bond program to be just as strong as you were last year.

Senator D'AMATO. Well, Commissioner, let me at this point suggest to you that one of my questions to you is going to touch exactly on the industrial revenue bonds. The fact that you were the former head of the Industrial Development Agency in Erie County, and understand and know the value of the valuable mechanism that IDB's are.

Unfortunately, we find, I think, simplistic thinking on the part of some who are charged with great responsibility in terms of writing the tax provisions. Some seem to have a fetish. If they want to do some things to stimulate the economy and produce revenue, I can think of a heck of a lot better ways than to go after IDB's. Maybe they don't need industrial revenue bonds in Texas. Maybe they would like to deprive the rest of the country of IDB's so that they can continue to attract business and industry, because they used them down in the south for many years, and now that the north begins to use them effectively to retain employment, I would suggest that it is rather unfortunate to think that we can close the deficit by reducing the use of industrial revenue bonds. And I think that Congressman Pickle does a great disservice to small business, to the retention of small business, to helping to finance real job creation in an oversimplistic, allout attack on IDB's.

He doesn't go after the abuses. I have offered to have our staff sit down with his staff innumerable times. They hide things. They hide things from the minority. Then they go out and they put forth a laundry list. They say, well, we are just going to correct the abuses, and if they actually enacted all of the things that they talk about, no one would be able to borrow moneys, because they make it so tight.

Then they say well, let's just make it available for blighted areas, and I would suggest to you that those areas, before they become totally blighted, are in need. Areas in transition. IDB's should not be a tool utilized in inner core cities where there is no hope, because they wouldn't be used there in any event, if we are going to make it that kind of a program.

And then to place artificial limits on the amount of capital that a corporation could or should invest over a period of time, and say if you invest more than that you don't qualify for IDB's is unconscionable.

And then to point repeatedly to several areas of abuses and say oh, look at the McDonald's stands that utilize IDB's. The fact is that most of those are franchises, and they are small, independent contractors who use them. Do you want to knock out fast-food concession stands? I would give that to them.

No, they don't want to do that. They want to keep that in there so they can use that as the catalyst to attack the entire program. Then they talk about the dirty book stores and the other past applications. All right, so let's recognize that. Let's get rid of them, but let's not kill the whole program.

So I hope that you as Commissioner will focus your attention on our State delegation and the delegations of others so that at least the membership of the House can stand up to the autocrat over there on the other side. He may not love me for saying this, but I don't love the way I see him handling this bill. And we can't even get any comment on it, and we just see this continual assault, and it is basically an assault aimed at small business.

We have used them very successfully, industrial revenue bonds, in our State. We are going to do that, and I hope that Congress doesn't give Mr. Pickle his—because I understand he is going to be leaving—a victory in this area. I think it would be a tragic defeat for utilizing the program that has not cost the taxpayers and prob-

ably has generated billions of dollars and hundreds of thousands of jobs nationwide that never would have come about; billions of dollars to the Treasury from people who were working instead of being out on the unemployment lines, et cetera.

So I commend you for being here, for your forward stance, for your support of these legislative initiatives aimed at stimulating small business, not only in our State but throughout the Nation.

Mr. DONOHUE. Senator, I would like to make one last remark or two. One is that I don't think the Congressman realizes what he has done with some of those provisions. Certainly he realizes that the ACRS provision, the new ACRS provision simply destroys the usefullness of the Industrial Revenue Bond.

Senator D'AMATO. Well, he knows exactly what he is doing.

Mr. DONOHUE. I wonder if he realizes, though——

Senator D'AMATO. Wait a minute. Excuse me, Commissioner. By eliminating ACRS what he does is tell potential users of industrial revenue bonds, that it is not worthwhile utilizing industrial revenue bonds.

Mr. DONOHUE. Absolutely.

Senator D'AMATO. So consequently, it is one of the laundry lists that I talked to you about, that eliminates the program. Pickle is not talking about reforms. He is talking about killing the program. And I am rather sick and tired of hearing the nameless bureaucrats who hide behind their desks over there in Treasury, who, coupled with the good Congressman, come up with these laundry lists of programs.

If you want to talk about reforms, then let's make the reforms. Let's look at the abuses, and if there are abuses treat the abuses. But let's not kill the program.

Go ahead. You had another remark.

Mr. DONOHUE. Well, I am just saying that——

Senator D'AMATO. Don't think he doesn't know what he is doing.

Mr. DONOHUE. I know that he realizes he kills the program with that. He may not realize what he does with the two $20 million caps. The effect of those provisions is to curb much of the investment that is being done by large corporations in aged plants throughout the northeast. Because now there is a very——

Senator D'AMATO. He doesn't know that?

Mr. DONOHUE. I don't know if he knows it. I am wondering if he understands that.

But I can tell you this much, Senator. What is happening in New York State is that because of the ability now to place an IDB in the short-term market, an IDB they can now be priced at below 5 percent. Now, that interest rate may not be terribly important in constructing a new facility in the southwest, but it is extremely important in rehabilitating an old facility in Buffalo. I can tell you that. And that is what is happening. We are getting a very strong movement on the part of larger corporations to renovate old plants in the older areas of New York State, and I am relatively sure that it wouldn't happen without that kind of a very deep incentive.

The other thing is it turns out that those provisions are anti-industrial. What Treasury hasn't thought out, is that actually if it wants to promote commercial projects, one way to do it is to impose the twin No. 20 millimeter caps. Commercial projects are generally

done by developers who form a partnership which is a new business entity with no affiliation to old business entities and therefore doesn't come under the capital expenditure test at all. It has no capital expenditures over the past 3 years.

The result of the twin caps is that IRB's will be used for commercial development projects, and not for industrial projects, in many, many instances. So it is an anti-industrial bill in large part.

Lastly, Senator, I just want to mention that your ability to work with SBA and arm wrestle them into allowing the 503 program to be coupled with the IRB program is becoming one of the more important capital formation tools for the State of New York.

As you know, the New York State Job Development Authority is an umbrella industrial revenue bond program. What we are doing is coupling the 503 with the job development authority loans, making that program available to small businesses. Intake is done through local development companies around the State. We are creating a retail banking network throughout the State of New York utilizing the opportunities that you have provided us in this particular program. So we thank you.

Senator D'AMATO. Well, Commissioner, let me thank you. Let me also acknowledge that this really comes about in great and large measure as a result of the tireless and the untiring work of staff, both majority and minority, from the leadership of Senator Weicker who has been in the forefront and who has given us the support in carrying these messages, and my good colleague who joins us here, Senator Sasser. And it has really come about in a very bipartisan way. And we must continue it that way.

So, I certainly thank you for your comments and your participation.

Mr. DONOHUE. Thank you for the opportunity.

[The prepared statements of Mr. Levitt and Mr. Donohue follow:]

STATEMENT OF HON. ARTHUR LEVITT, JR., CHAIRMAN OF THE BOARD, AMERICAN STOCK EXCHANGE

Thank you, Mr. Chairman. I'm honored to be the lead-off witness at these important hearings.

During these sessions, your Committee will be asked to weigh the relative merits of tax and other incentives for small business versus potential loss of revenues to the government. You will be reminded of a good deal of research—some growing out of the last White House Conference on Small Business, and some generated by your own extremely able staff.

You will also, of course, be discussing specific legislative proposals. And I certainly want to comment on them.

But in considering my testimony today, I felt my real value as a lead-off witness would be to move beyond the facts and figures. And with your permission, I'd like to describe, based on my own experience, part of the impact of small business on our people, our economy and on the major problems facing this country.

To start, let me focus on some people who once worked at the American Stock Exchange. Good people, restless people, people who believed in the American dream of taking risks and of starting their own businesses.

For much of last year, the Amex, like many organizations during this difficult time, only hired to replace departing personnel. But at the same time, there were those in our ranks at the Amex who were creating jobs—although we didn't think of it in those terms at the time.

I'm referring to the people who left our Exchange—striking out on their own to become their own bosses.

Remember, every time a person left and started a new business, he or she was replaced. So immediately, the move created at least one new person working in our economy.

Often, the person leaving would start in business with their husband or wife. Add another job to the total.

Some of the people who left obviously moved into areas that were a direct extension of their Amex jobs. One of our financial analysts set up a CPA firm. Another offered an investment advisory service to individuals.

Three individuals in our Press Relations area left separately to establish public relations firms.

But what surprised me when I started to track down cases for this testimony was how far afield many of our ex-employees went. One woman, in our Personnel Department, let town with her husband and established a wholesale/retail fish operation out on Long Island. The other day, when I asked how they were doing, I was told their small operation was very successful and that they were employing three or four young people part-time.

Now, that might not seem like a major point for Senate hearings. But I would note that during the long months of the recession, that young couple was doing more to solve a difficult national employment problem than many large companies with multimillion dollar budgets.

Let me go on. Another of our ex-employees left to set up a men's haberdashery shop. It proved so successful that on a visit to Florida, he decided to open another branch.

Several employees left to open restaurants—one of the growth industries of our day.

One left to begin a personal computer outlet and, I'm pleased to say, caught the boom in that industry.

Another opened a roller skating rink.

I can't give you complete figures because our personnel records never focused on this aspect—being mostly concerned with whether conditions were satisfactory on the Amex job and whether we were losing people for competitive salary reasons.

I'm pleased to say that our conditions are good and we do tend to keep our people. But even these few examples, and there are others, illustrate the dynamics of job creation by small business. First, the person leaving. Then, those they hire. Cashiers, salespeople, waiters and waitresses, drivers, stockroom help, repair people. Add to that, job creation in suppliers, furnishings, construction of new facilities.

These were recent examples, but I can't resist going back to 1967 to a 24-year-old economist with the Amex who left to establish a new magazine, Institutional Investor. You probably all read last year how this entrepreneur, how the head of a multimillion dollar enterprise, fulfilled a lifetime dream by conducting a Mahler symphony at New York's Avery Fisher Hall. So for at least one performance, a full symphony orchestra found employment.

Now let's take this same process at work at the Amex and move to other organizations—those involved in more technical activities, those whose employees would more likely be engineers and scientists. I assure you, the same process is at work.

The Friday before last, we gathered some of the securities industry's top analysts at the Amex for a seminar on telecommunications. On the platform were six Amex companies. None of the six had even been in existence 30 years ago. Two, in fact, were founded in the 1970's and three in the 1960's.

Now, they're established firms, traded on our Exchange, providing thousands of jobs, competing in overseas markets, holding off foreign competitors in this country, and contributing advanced technology to our industries.

I could go through industry after industry—energy, construction, retailing, health care and so on—and point to the same process—now well established companies contributing jobs, products and service, companies that didn't exist or were fledgling enterprises just a few years ago.

I'm not suggesting, of course, that everyone who sets out on this entrepreneurial path is going to succeed. We all know the appalling record of bankruptcies in this recession. Even now that the recovery seems firmly underway, last week's figures from Dun & Bradstreet show that bankruptcies through the first half of 1982 were 27 percent above last year's record, which was the highest since the early 1930's.

Nor am I suggesting that if this Committee does nothing, Americans will give up the dream of starting their own business. They won't. The hope runs too deep.

We know that last year, 567,000 new businesses were started—the second highest year on record, and just slightly below the 1981 all-time high. And each start-up is a very personal, very intense, special case.

I know that when I began in the securities field, my partners and I had many anxious days struggling to get our small firm, the predecessor of what is now known as Shearson/American Express, off the ground. Many times we wondered if our operation was viable.

In the years since then, one of our partners has gone on to head a newspaper in Litchfield, Connecticut. A second is a Broadway producer of such shows as Nine, Amadeus and Sophisticated Ladies, A third heads one of the largest furniture companies in the World. I'm, of course, at the Amex. Another partner remained with Shearson as it grew to number thousands of employees here and abroad, and he's now President of American Express. So each in our own way has contributed to the economy and to job creation.

I'm not suggesting that we make the process of small business formation fail proof. I don't think that's possible . . . or even desirable.

But I do urge that when you weigh the specific proposals before you, that you consider all the contributions small business makes . . . and all the obstacles it faces.

A good rule of thumb is that whatever is difficult for business is harder for small business.

Today, a Japanese firm can afford to invest five times as much as its American counterpart in the same Research & Development project because the cost of capital is so much lower in Japan. That figure is for all business. As you know, the cost of capital is even higher for small business.

Is business burdened by a mound of paperwork and regulations? The mound is a mountain for small business.

Is business pressured by legal fees, and interest rates and taxes? The pressure is genuine pain for small business.

Congress can ease that pain by enacting some of the small business legislation that has been introduced. For example, S 1043, the small business Capital Formation Tax Act, which you, Senator D'Amato introduced and which is co-sponsored by Senator Weicker and nine other of your colleagues in the Senate.

Its provisions would address many of the key concerns of the last White House Conference which have not yet been enacted into law. It would facilitate the process by which small business attract and retain needed capital.

For example, as you know, Section 7 of the Act encourages a recycling of capital gains into other small businesses. Section 3 enables small business people who have spent five years or more in building their enterprises to enjoy the fruits of their labors.

The other provisions of the Act were also strongly supported by the last White House Conference and I join in that support. They include such provisions as lowering the corporate tax rate and and increasing the capital gains deduction for small business.

I understand the estimates are not complete on what the cost of these proposals would be or of their effect on the recent budget resolution, but I believe the principle behind them are as strong now as when they were put forward by the Small Business Conference in 1980. And I would hope that the Congress and the President will see them as consistent with the long-range economic health of the nation.

In addition, I also urge favorable consideration of S.842, the Small Business Participating Debenture Bill—Another important recommendation of the last White House Conference. This would create a means for small business people to raise capital without sacrificing the key quality and strength of the entrepreneur—equity ownership in his or her business.

Mr. Chairman, although I think these measures make sense in purely economic terms, I would also urge that you consider the spirit they infuse into our national life.

As Chairman of the last White House Conference on Small Business, I spent about two years traveling around the country talking with small business people. In addition, as Chairman of the Amex, I am continually meeting with medium and larger businesses, speaking on college campuses, and meeting with civic leaders and people in other professions.

What I find very encouraging and very exciting is that entrepreneurship has recaptured the American imagination.

At business schools, the deans tell me that the classes on starting your own business are jammed with students. And surprisingly, when I address undergraduates in the liberal arts departments, I get the same questions, "How do I start my own business? Do you think it's wise?"

In a recent study, Professor Karl H. Vesper of the University of Washington writes of an unorganized and invisible constituency for entrepreneurship—for the startup of enterprises.

My experience around the country would certainly support that view. I am convinced that in addition to the figures we've seen on the thousands of new businesses

started each year, you must take into account this vast invisible constituency of Americans.

Women whose husbands are working, hubands whose wives are now in the work force and who are now better able to take economic risks. And with them, an unnumbered multitude who are gathering their savings, weighing the risks, awaiting the opportunity to become entrepreneurs. Minorities, majorities * * * people from all walks of life.

This underground constituency can provide a huge army of support for the measures you support that will aid existing small businesses and encourage new ones.

The big stumbling block is capital. Whatever this Committee can do to encourage access to, and retention of, capital for small business will be repaid in a flowering of economic vitality throughout our society.

I wish you every success in your efforts.

Thank you.

STATEMENT OF HON. WILLIAM J. DONOHUE, COMMISSIONER, NEW YORK STATE DEPARTMENT OF COMMERCE, ALBANY, N.Y.

I want to thank you, Senator, for providing me with this opportunity today to express my support for the Small Business Capital Formation Tax Act and to discuss other issues vital to small business development in New York State.

In summary, my testimony will endorse the investment incentives provided in S. 1043 and the bills to create small business participating debentures and special job tax credits.

Small businesses face chronic handicaps in raising investment capital. Furthermore, I believe we now have enough statistical evidence demonstrating the key role small businesses play in our economy and we should commit ourselves to implementing programs to improve small business' access to capital.

Each of use is familiar with the findings of the recent MIT and Brookings studies of job development in the private sector. Although these studies differ markedly in the extent to which they find small businesses responsible for net job creations in recent years—the MIT study found small businesses created 80 percent of all net new jobs and the Brookings study said small businesses were responsible for 40 percent of such jobs—they agreed on one matter of special significant for New York State and the Northeast. They agreed that areas suffering through periods of slow growth rely more heavily on small businesses to generate new jobs than do those areas that are experiencing rapid economic development.

The MIT study found that between 1972 and 1976 firms with 50 employees or fewer created virtually all net new jobs in the Northeastern states.

The Brookings study found that between 1978 and 1980, small firms were responsible for about 78 percent of all employment growth in the Middle Atlantic states. On this point then, these landmark studies establish the importance of small business to stagnating economies.

As you know, Senator, the unemployment figures for this June showed an overall decline in the jobless rate for the nation, but an increase in umemployment in New York State and the Northeastern industrial states. Western New York in particular has suffered greatly. Closings scheduled by Bethlehem Steel and General Motors will lay off approximately 9,300 workers this year and next and will have a devastating effect on the economy of the entire state and the municipalities and people located in Western New York. We are doing everything we can to ameliorate the impact on the people involved, but the damage here can't be overestimated. Furthermore, as these studies and our own experience have underscored, we can't look to new heavy industries to bail us out. We are in for along effort, and we have to concentrate our work on targeting assistance to growth industries and new and small businesses.

New York State has more than 400,000 small businesses. They account for 98 percent of all business establishments in the state and 49 percent of all private sector employment.

In the growing high technology manufacturing sector, small businesses make up 81 percent of all such firms in our state. We are working to enhance the advancement of these firms and the development of new small ventures through several programs, primarily through our Corporation for Innovation Development (CID), a subsidiary of the state's Science and Technology Foundation, of which I serve as chairman.

A CID revolving fund made up of matching $1 million grants from the federal Economic Development Administration and New York State is used to make high-

risk start-up capital available to new ventures. Thus far, the CID program has financed six new businesses with equity valued at only $705,000. The businesses to which we contribute must meet a rigorous test, including convincing our board of directors that the new business offers an innovative technology, a good chance of commercial success evidenced by a professional and thorough marketing plan, and substantial future benefits for the state, particularly new jobs.

The State Department of Commerce includes a Division for Small Business Development and a Division for Minority Business Development. Each of these units has a mandate to advocate policies and offer programs designed to spur expansion of existing small businesses and to assist new business development. In addition, they work with our other economic development divisions to target specific programs, such as our High Tech-Made in New York program which promotes high-tech products in overseas trade shows. We're interested in exploiting every good idea we can develop in order to stimulate business development, and I think we have a good record in this.

Nevertheless, New York State's resources are limited; there is little we can accomplish in building large pools of new capital for small business investment.

The present structure of federal business taxes and investment regulations and the nature of our capital markets combine to deny ready capital to small and new businesses. This is nothing new—particularly for equity and long-term debt, even where there are strong, potentially profitable investments. Large banks, insurance companies and other financing institutions are not closed to small companies; it is simply economically inefficient—in their eyes—to consider investment in such companies.

S. 1043 includes several important provisions which could be very effective in focusing capital investment on profitable and potentially profitable small businesses.

The proposed revisions to the federal corporate tax rate structure will provide direct, straight forward help by increasing retained earnings and generating the additional revenue necessary for investment in expanded facilities and employment.

The three incentives designed to attract more equity capital to small businesses would make such investments more profitable and, thus, more attractive to those persons and institutions managing venture capital and investment funds.

And, finally, significant savings in operational costs will be possible for those small firms eligible to use the cash receipts accounting methods under your bill.

In summary, this bill contains direct incentives for small businesses to attract investment, to increase earnings, to expand successful operations, to hire new people and to continue and extend the vital contribution they make to economic recovery in the Northeast.

I'd like to comment briefly on the other bills before you today.

S. 842 could prove to be of special importance. The small business participating debenture—if it proves attractive to the investment community—could provide a new market for small business investment. There is minimal experience in New York State with hybrid securities such as this, but I would assume that if this idea takes off, it will take off first in New York, and you can bet we will use it to our best advantage. There's no reason to delay its creation any longer.

S. 371, as Senator Sasser has pointed out, provides an enhanced jobs tax credit for labor intensive small companies. Again, in this instance we have an incentive which provides a direct economic signal to its constituency. We think it will work in New York and urge its approval.

In closing, Senator, I'd like to discuss a problem I know you are familiar with and with which your past and present help has been invaluable. The continued effort to further restrict the use of IDBs for industrial development purposes will be more than counter-productive. The proposed restrictions on company eligibility and the stretched depreciation schedules will effectively kill the program. In New York, we depend on these bonds to help rehabilitate aged manufacturing facilities and to provide the much needed capital for project expansion by smaller, fast-growing companies.

It seems arbitrary for Congress to enact additional restrictions before it has had the benefit of any analysis of the effect TEFRA has on IDB programs. TEFRA has had a real effect on throughout the country, and I urge you to continue your efforts to support reasonable and necessary changes in this program and to hold off those seeking to deny us one of our most needed and effective tools for industrial development.

Thank you.

Senator D'AMATO. Before we call the first panel, Senator Sasser is here and I know that he has some pressing engagements.

We have our first panel, Mr. Stoner, Mr. Santos Abrilz, and Mr. Michael Bateman.

Senator Sasser.

Senator SASSER. Mr. Chairman, I have an opening statement which I ask unanimous consent be included in the record today.

Senator D'AMATO. So ordered.

[The prepared statement of Senator Sasser follows:]

STATEMENT OF HON. JAMES R. SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Mr. Sasser: Mr. Chairman, I commend you for calling these hearings today to explore various small business capital formation and retention proposals and the job creation potential of these proposals. Hearings such as these help underscore the significant role small business plays in furthering our economic recovery. We are all familiar with the job creating potential of small business, and I am proud to be involved in this effort of examining new ways of assisting small business.

As pointed out at the White House Conference on Small Business and the S.E.C. Government, Business Forum on Small Business, our tax code looms very large in the question of where can we act to effectively assist small business. Our present tax system is loaded with incentives for capital investment by large corporations, yet precious little is being done to provide incentives for investment in human assets, human resources. At a time when the jobless rate is still over 10 percent and the business bankruptcy rate is over 500 a week, we must endeavor to stem this tide.

One thing we can do is to provide additional tax credits to small businesses, helping them grow and prosper, and thus helping the economy as a whole.

I feel tax credits are most appropriate now for, as Frank Swain, Chief Counsel for Advocacy at the Small Business Administration, has pointed out, a jobs tax credit is the "fastest, least intrusive mechanism to stimulate employment." Jobs tax credits speed hiring that a small firm may be contemplating for the future. In addition, jobs tax credits can reduce labor costs for small firms, thereby preserving precious capital.

Such a tax credit is very timely when we realize that small business have not been receiving their fair share of tax credits. Estimated tax benefits to small businesses represented only about 18 percent of the total tax cuts in 1981, A congressional study showed, and the figure is projected to shrink to only 12.7 percent for 1982 and a paltry 9.2 percent by 1986. It's clear that small businesses, the key to our Nation's economic health and well-being, are being deprived of the logical tax incentives than can help them prosper.

I am proud to have taken a leading role in promoting greater use of jobs tax credits with the introduction of S. 371, the targeted jobs tax credit amendments act of 1983. While the targeted jobs tax credit section of the Internal Revenue Code is now available to business hiring individuals from one of several specified groups, my legislation creates a broad target group of all men and women who have been unemployed for a year or who have exhausted all available unemployment benefits. Further, S. 371 increases the amount of tax credit available to 75 percent of qualified first year wages when the hiring company is a small business.

This legislation has several features which commend it for implementation. With the pre-certification process contained in S. 371 I have attempted to reduce the amount of government red tape and bureaucratic interference in the day-to-day operations of a small firm. Fear of such government contact has been one of the leading reasons small business firms haven't utilized such tax credits in the past. I feel S. 371 goes far in removing this hurdle.

And while S. 371 creates a broader group than the existing target groups, it is not a bill that would prove as costly as a general jobs tax credit. Indeed, revenue estimates provided by the Joint Tax Committee on S. 371 show that it is not an expensive bill. In fact, any revenue loss will be more than offset in reduced spending for programs such as food stamps and unemployment compensation as persons go back to work. Furthermore, increased employment will mean greater revenue for the Federal Government.

Targeted Jobs Tax Credit Amendments Act of 1983

Fiscal year:	*Billions*
1984	—$0.6

1985	−0.9
1986	−0.7
1987	−0.4
1988	−0.1

The tax credit contained in this bill is particularly attractive to labor intensive industries. The S.E.C. forum indicated that 97 percent of all small businesses are service-related firms that can put marginal workers to productive use. I feel that S. 371 is broad enough in its scope to provide an incentive for these firms to generate such additional jobs.

The type of credit contained in S. 371 has been enthusiastically received by members of the small business community. I have been contacted by several small firms indicating their support for this measure and would like to make this correspondence a part of the record at this point.

Considering the fact that past tax credits either have been too small to be much of much assistance or have not been sufficiently publicized to be used properly, I feel the credit contained in my legislation could go far in aiding capital retention for small firms and in reducing unemployment.

For too long these types of tax incentives have been created almost exclusively for large corporations and have focused totally on equipment. I believe it is crucial that the Federal Government recognize the importance and address the needs of small businesses by providing them incentives for investing in human as well as capital assets.

I look forward to hearing from our witnesses today on this and other small business proposals before the committee today. I especially want to welcome Mike Bateman, a C.P.A. from Nashville, Tennessee, and I am eager to hear how the practicing accountant views my proposed tax credit. My good friend, Bill Nourse, was to be here today, but being a small business owner he has had to tend to the shop so to speak and can't be with us.

Senator SASSER. Mr. Chairman, I want to welcome to our committee this morning my distinguished constituent from Nashville, Tenn., Mr. Mike Bateman. Mr. Bateman is a partner in certified public accountants firm of Bateman and Page in Nashville, Tenn. He is responsible for tax matters in his firm, and he has developed a keen, continuing and, I think, very perceptive interest in tax matters as they affect small business in this country. I am delighted to see Mr. Bateman here this morning. I want to commend him for the good work that he has done over the years and the splendid perception he has into the problems of small business in this country.

Senator D'AMATO. Thank you, Senator Sasser.

Why don't we begin with the testimony. Gentlemen, if you wish to summarize your testimony we will take your testimony as if read in its entirety. It will be included in the record, and then if there are any high points that you would wish to summarize, that might save some time and get us right to the meat of the matter.

STATEMENT OF ROBERT STONER, EXECUTIVE VICE PRESIDENT, WINFIELD INDUSTRIES, INC., ACCOMPANIED BY SANTOS T. ABRILZ, JR., PRESIDENT, APOCA INDUSTRIES, INC.; AND MICHAEL R. BATEMAN, PARTNER, BATEMAN & PAGE, CERTIFIED PUBLIC ACCOUNTANTS

Mr. STONER. Senator D'Amato, I shall do that.

Senator D'Amato, Senator Sasser, I appreciate this opportunity to participate in this hearing concerning recommendations to the Securities and Exchange Commission's form report.

As the record shows, my name is Robert Stoner. I am executive vice president of Winfield Industries, a small manufacturing firm located in Buffalo, N.Y. Previous to this position I was owner and

president of Winfield, having sold it to another individual entrepreneur within the past year.

In addition to this, I am chairman of the Council on Small Business Enterprise, a chamber of commerce-related organization serving approximately 2,000 small business entities in the Buffalo area. And I am also privileged to be a member of the New York State Governor's Advisory Board on Small Business.

From both business and personal experiences, and exposure to many persons and issues, I am totally aware of the restraints placed upon small business startups and expansions by difficulties in obtaining sufficient capital.

It is well documented, as has been mentioned earlier today, that the small business person's major sources of capital are family and his own equity, retained earnings, and commercial bank loans. The first two sources are very limited, and the third has become very expensive and sometimes impossible to obtain in recent years.

Increasing and/or making less costly funds available to small business will certainly accelerate job formation in a segment of our economy which has proven its ability to do just that.

In 1980, at the White House Conference on Small Business, at which I was a delegate, we arrived at early consistency of views expressing our concern about capital retention by recommending a more graduated tax rate scale up to $500,000. Subsequent to that conference, at a time when interest rates and inflation continued to rise, small business suffered disproportionately to their numbers because of their traditional dependency on bank loans as a prime source of capital. As a result, bankruptcies reached levels of the 1930's and many of which were contributed to the unprecedented cost of loans.

Now that our inflation seems to be somewhat abated and the prime has come down somewhat and our recession appears to be over, it is imperative that we not forget the bitter lessons of the past few years.

Regarding the specific proposals of S. 1043, I do not consider myself an expert in the area of taxation and its impact upon the various segments of our economy. However, as one deeply involved in small business both personally and as a spokesman, I will offer my considered views.

As one who ran a small manufacturing business for about 12 years, I can—without hesitation—say that our growth—and along with that, job creation—would have been accelerated had more capital been available. During my early business ownership years, a buy-out agreement with previous owners prevented my obtaining loans from any source, and the majority of after-tax earnings were pledged to retire the buy-out indebtedness.

This meant, for all practical purposes, no investments in equipment or facilities occurred. Under the rates you propose in Senate Bill 1043, retention of additional capital would have allowed me to complete the aforementioned buy-out within 6 years instead of the 7 it actually took, thus creating additional funds to start investing in the business.

I can state that once the buy-out obligations were satisfied and until the company was sold last year, all after-tax profits were left in and invested in the business. A larger share of profits retained

would have resulted in faster expansion since, at the time when this was occurring, interest rates were beginning to increase dramatically, and as a result I essentially eliminated loans as a potential source of capital.

In other words, I limited expansion to that permitted by after-tax earnings rather than incur the high cost of borrowed money.

Retained capital, in my opinion, is the single most important source of capital for the existing small business enterprise. Sections 2 and 5 of S. 1043 will add to this valuable source. As much as I will endorse and advocate other sections of your tax proposals later in this testimony, these sections on retained earnings are my number one priority. You can be virtually guaranteed that the typical business owner will invest his after-tax earnings in his business assuming, of course, that the market opportunity is such that it is prudent for him to do so.

Now, concerning the sections of your legislation which address the increase in capital gains exemptions, offer a 10-percent tax credit and permit capital gains rollover, I obviously can only applaud your proposals. For those investors willing to put equity capital into new small business ventures there should be an increased capital gains deduction over the current 60 percent. This larger capital gains deduction will give greater reward for those people willing to invest in small businesses. It is certainly a greater risk to invest in a new small business venture as compared to investments in largely held stocks such as General Motors and IBM. And therefore the rewards for this risk should be greater.

The proposals of S. 1043, sections 3, 4, 6, and 7, taken together, should stimulate a flow of venture capital into the high risk business startup. In this regard, let's look at my own situation.

Upon the sale of my business last year I became immediately subject to a net capital gains tax of about 20 percent. Of the remaining amount, I have invested primarily in quality stocks of major U.S. corporations, tax-free municipal bonds, and U.S. Treasury notes. My capital has been moved from the small business, entrepreneurial segment of our economy to the large business and Government segment of our economy, for the simple reason that there is no tax incentive for me to do otherwise.

In fact, through municipal bond ownership there are tax incentives to encourage this move. What incentive is there for me to leave my capital in high risk areas under today's tax code?

Your proposals to bring risk versus reward more into balance would certainly correct this problem.

Now, beyond the immediate goal of job formation, which your excellent bill directs itself toward, I would like to believe that your proposals go toward even a higher purpose. Small business is well-known to be the bastion of competitive free enterprise in our economy. As small business prospers, so will the entrepreneurial spirit that has carried our country so far in such a short period of time. Your efforts may well help to preserve this great system of ours so that your children and mine can enjoy the blessings of freedom, and are privileged to prosper or fail as one might so choose to do.

Obviously, no single action or bill will solve all of our future problems. The actions you propose, however, are certainly a step in the right direction.

In summation, I could not speak more enthusiastically about the merits of your proposed bill, but with one precautionary note. Most small business persons I speak to are seriously concerned with the current taxing and spending levels of our Federal Government, which are going to create large deficits under the budget proposals now passed by Congress. Their legitimate fear is that interest rates and inflation will again return to the heights of the past 2 years and result in another round of interest cost-generated bankruptcies.

Most small business persons I know would give up the tax benefits to themselves of the type you propose in your legislation if they could be assured of an economically stable future in which to operate their business. They would sacrifice their business if other economic entities impacting on this same problem would similarly sacrifice theirs. Even if the legislation you propose were entirely passed as now written, commercial bank loans will probably still be the single most important source of capital for the small business person. To allow interest levels to return to previous highs or even higher is a totally unacceptable prospect, and small business will correctly hold the Federal Government and those that run it responsible if this should occur.

Thank you, Mr. Chairman and subcommittee members, for this opportunity to speak before you. I wish you well in your efforts on behalf of small business, and stand ready to be of whatever further assistance I can.

Senator D'AMATO. Thank you, Mr. Stoner.

Before I call on Mr. Abrilz and Mr. Bateman, let me say that we have received a statement from the Honorable John Chapoton, Assistant Secretary in the Department of Treasury in charge of tax policy. I will ask that it be included in the record.

[The prepared statement of Mr. Chapoton follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUL 13 1983

Dear Mr. Chairman:

In response to your invitation of June 17, 1983, I am pleased to submit the views of the Department of the Treasury on the proposals for small business capital formation being considered by your Subcommittee on Urban and Rural Economic Development. Thank you for the opportunity to address these important issues.

The Office of Management and Budget has advised that there is no objection from the standpoint of the Administration's program to the submission of this statement to the Congress.

I am sending a similar letter to Chairman D'Amato of the Subcommittee.

Sincerely yours,

John E. Chapoton
Assistant Secretary
(Tax Policy)

The Honorable
Lowell Weicker, Jr.
Chairman, Committee on Small Business
United States Senate
Washington, DC 20510

Enclosure

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m. EDT
July 13, 1983

STATEMENT OF THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
SUBMITTED TO THE
SUBCOMMITTEE ON URBAN AND RURAL ECONOMIC DEVELOPMENT
OF THE SENATE SMALL BUSINESS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Department of the Treasury on S. 1043, the "Small Business Capital Formation Tax Act", S. 842, which provides special tax treatment for small business participating debentures, and S. 371, the "Targeted Jobs Tax Credit Amendments Act of 1983".

First, I would like to emphasize that the Treasury Department shares your interest in the vitality of small business. We strongly believe that the small business sector is essential to innovation in the economy and vital to our efforts to promote growth in employment opportunities.

Tax policy plays a major role in our approach to the problems of small business. Over the past three years Federal tax rates on all forms of small business were significantly reduced. The reduction in the maximum personal income tax rate of 20 percentage points and the reduction in other rates of over 25 percent directly benefit the vast majority of small businesses, which are organized as sole proprietorships or taxed as partnerships. Over 85 percent of all small businesses are subject to Federal personal income taxes only and are not subject to the corporate income tax. The Administration's Accelerated

Cost Recovery System (ACRS) also provides substantial tax reductions for all forms of small businesses. One aspect of ACRS of particular value for small businesses is the expansion of investment credits for shorter-lived equipment. In addition, an option was provided to expense machinery and equipment investments of up to $10,000 after 1985 ($5,000 in 1983, and $7,500 in 1984 and 1985) and the amount of used equipment that qualifies for the investment credit was increased from $100,000 to $125,000.

I am sure you share our concerns about the projected budget deficits for the current and future years. Our dedication to bringing expenditures in line with tax revenues precludes us from supporting the proposals in S. 1043, S. 371 and S. 842. Our estimates indicate that these bills would result in revenue costs that approach $11 billion per year. In addition to revenue considerations, we have further concerns as to whether the forms of assistance envisioned could be provided without damaging public confidence in our self-assessment tax system. These are tax policy questions that I know this Subcommittee wishes to address, particularly in light of the budget situation and the currently accelerating rate of business expansion.

Following is a brief summary of the tax provisions of S. 1043, S. 842 and S. 371, their relationship to current law, and their revenue costs. S. 1043 contains six substantive sections which are designated as sections 2 through 7 of the bill.

Section 2

Present Law. Section 2 concerns corporate tax rates. Present law provides for reduced rates of income tax on the first $100,000 of a corporation's taxable income. Beginning in 1983, the corporate tax rates are 15% on the first $25,000 of a corporation's taxable income; 18% on the portion of taxable income between $25,000 and $50,000; 30% on the portion of taxable income between $50,000 and $75,000; and 40% on the portion of taxable income between $75,000 and $100,000. The rate of tax on corporate income in excess of $100,000 is 46%. The special reduced rates on the first $100,000 of corporate income produce a $20,250 tax savings for a corporation, compared to the tax that would be due on $100,000 of taxable income at the regular 46% corporate rate.

Proposed Change. Section 2 would reduce the tax rates on the first $200,000 of a corporation's taxable income. The rates would be 12% on the first $25,000 of taxable income; 15% on the portion of taxable income between $25,000 and $50,000; 20% on the

portion of taxable income between $50,000 and $100,000; 30% on the portion of taxable income between $100,000 and $150,000; and 40% on the portion of taxable income between $150,000 and $200,000. The rate of tax on income in excess of $200,000 would remain at 46%. This revised rate structure would produce a total tax savings over current law of $750 (a 20% reduction) for companies with $25,000 of taxable income; of $1,500 (a reduction of 18%) for those with $50,000 of income; and $9,000 (a reduction of 35%) for a $100,000 corporation. Corporations with taxable income of $200,000 would obtain the maximum savings of $20,000.

The total revenue cost of this provision would be $2.5 billion per year.

Section 3

Present Law. Section 3 concerns the portion of capital gains subject to personal income tax. Individuals are entitled to a capital gains deduction of 60% of the excess of their net long-term capital gains over net short-term capital losses. Capital assets, such as most corporate stock, generally must be held for more than one year in order to qualify for the 60% capital gains deduction. The one-year holding period generally includes the holding period of other property that was exchanged for the stock in a tax-free transaction. The capital gains deduction has the effect of reducing the maximum ordinary tax rate on capital gains of individuals from the 50% rate applicable to ordinary income to 20%.

Proposed Change. Section 3 would increase from 60% to 80% the amount of the capital gains deduction with respect to sales or exchanges of "small business equity investments" held for at least 5 years. A "small business equity investment" is any common or preferred stock of an eligible "small business", provided the holder has no right solely by reason of the passage of time to (i) receive payment of money or property with respect to the stock, or (ii) cause the issuer to repurchase stock. An eligible "small business" is one that has received no more than $1,000,000 for its stock or as paid-in capital as of the time the small business equity investment is made. The required 5-year holding period for a small business equity investment would be determined without regard to the normal "tacking" rules, so that holding periods for other property that was exchanged for the stock in a tax-free transaction may not be counted as part of the holding period of the stock.

The revenue cost of this section would be approximately $100 million per year.

Section 4

Present Law. Section 4 concerns corporate capital gains. In general, a corporation's capital gains and ordinary business income are added together in computing the corporation's taxable income, which is then taxed at the regular corporate rates discussed above in connection with section 2 of the bill. However, corporations that have long-term capital gains are allowed to pay an alternative tax if that tax is less than the tax computed at the regular corporate rates. The alternative tax is equal to the sum of 28% of a corporation's net capital gain plus the tax (computed at regular corporate rates) on the balance of the corporation's income.

Proposed Change. Section 4 would lower the alternative tax for corporations by reducing from 28% to 20% the tax on capital gains derived from sales and exchanges of "small business equity investments" of the type described in section 3 of the bill. However, unlike the special capital gains rules for individuals in section 3 of the bill, there is no 5-year holding period applicable to gains realized by corporations from small business equity investments. Thus, the regular 1-year capital gain holding period would apply.

The revenue cost for this provision would be about $25 million per year.

Section 5

Present Law. Section 5 concerns the cash method of accounting for small businesses. Currently, taxpayers are required to maintain inventories for any trade or business in which the production, purchase, or sale of merchandise is an income-producing factor. Inventoriable costs are capitalized and deducted when the inventory is sold. The primary reason for requiring inventories for tax accounting purposes is to match the cost of goods with the revenues obtained from their sale.

While taxpayers generally may elect to compute taxable income under either the cash or accrual method of accounting, any taxpayer that is required to maintain inventories must account for purchases and sales on the accrual method. Under the cash method of accounting, amounts are included in income when received; expenses are deducted when paid. Under the accrual method of accounting, amounts are included in or deducted from income when (i) all events have occurred to fix the right to receive the income or the obligation to make the payment, and (ii) the amount of the income or liability can be estimated with reasonable accuracy.

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Taxpayers who are required or permitted to change a method of accounting are required to adjust income in the year of change to account for any item of income or deduction that would be duplicated or omitted as a result of the change. In limited cases, this adjustment may be spread over a period of 10 years.

Proposed Change. Section 5 would permit certain small businesses to elect to use the cash method of accounting without regard to the current requirement to use inventories. Thus, taxpayers who make the election would include sales in income when proceeds are received and would deduct all noncapital expenditures, including inventoriable costs, paid during the taxable year. The provision would be effective for taxable years beginning after December 31, 1982.

To qualify for this special provision, a taxpayer's average annual gross receipts for the 3 taxable years ending with the year of change cannot exceed $1,500,000. In addition, in the case of a noncorporate trade or business, at least 50% of interest in capital and profits and, in the case of a corporation, at least 50% of voting power and value of all stock, must be owned by active participants in each of these three years. The term "active participant" means an individual who is actively involved in the management of the trade or business and whose principal business activity is that trade or business. The election once made will be effective for all subsequent taxable years unless the taxpayer fails to meet either the gross receipts or active participant test or receives the Secretary's permission to revoke the election. Finally, any income adjustment resulting from a taxpayer's election to use the cash method will be taken into account over a 10 year period.

This proposal would cost about $3.0 billion per year.

Section 6

Present Law. Section 6 concerns tax credits for investing in small business equity. Present law provides no tax credits for investing in the stock of small business corporations defined in Internal Revenue Code ("Code") § 1244(c)(3), small business investment companies operating under the Small Business Investment Act of 1958 (SBICs), or business development companies defined in § 2(a)(48) of the Investment Company Act of 1940 (BDCs). SBICs and BDCs are venture capital entities that invest in small businesses. A "small business corporation" generally is a corporation that does not receive more than $1,000,000 for its stock or as paid-in capital.

Present law does provide, however, that losses on certain stock of small business corporations (up to a maximum of $50,000 per individual or $100,000 on a joint return) and losses on stock of SBICs are treated as ordinary losses for tax purposes. (Code §§ 1244, 1242.) This special ordinary loss treatment in part was made available to induce investments in risky small business enterprises.1/

Proposed Change. Section 6 would provide a nonrefundable credit equal to 10% of the cost of any "qualified small business investment" purchased by the taxpayer during the year. A "qualified small business investment" is preferred or common stock of a SBIC, BDC, or a small business corporation (as defined in Code § 1244(c)(3)) that was acquired in exchange for property (other than stock or securities), but only if (i) no payments with respect to the stock are required solely by the passage of time, and (ii) the stock is not subject to a mandatory repurchase by the issuer less than 5 years after its purchase by the taxpayer.

This credit would cost about $50 million per year.

Section 7

Present Law. Section 7 concerns the tax-free rollover of capital gains. In general, unless a nonrecognition or other special Code provision applies, gains from the sale or other disposition of property are recognized currently for tax purposes. There are, however, a number of statutory provisions under which gains or losses are not currently recognized if property is exchanged for or replaced with other qualifying property. One such provision permits nonrecognition of gain when property is involuntarily converted into money (through destruction, condemnation, etc.) and the taxpayer purchases replacement property similar or related in use to the converted property within a specified time period (Code § 1033). A similar nonrecognition rule is available to defer the gain on the sale of a principal residence if a new principal residence is acquired within a specified time period (Code § 1034).

1/ SBICs receive certain other advantages under the tax laws, including a 100 percent dividends received deduction (Code § 243), ordinary loss treatment with respect to losses on bonds or stock acquired through exercise of a convertible debentures (Code § 582(c)(1)) or stock acquired through exercise of certain convertible debentures Code § 1243), and exemption from the definition of a "personal holding company"

In general, the basis of the property acquired in a nonrecognition transaction is reduced by the amount of gain that was not recognized currently.

Proposed Change. Section 7 generally would provide that if any property is sold or exchanged by the taxpayer and within 1 year from the sale or exchange any "qualified small business investment" is purchased (for cash or by exchange of property), the taxpayer may elect to recognize the gain on the sale or exchange only to the extent that the amount realized from the disposition exceeds the cost to the taxpayer of the qualified investment. Gain from a sale of qualified small business investment stock also would qualify for nonrecognition treatment if the sale would have qualified for capital gain treatment under the redemption rules of Code § 302(b) had the stock sale been made to the issuing corporation.

Qualified small business investments eligible for this "rollover" treatment are the same category of stock investments for which the tax credit provided by section 6 of the bill would be allowed. Thus, the new tax credit and the gain deferral provision could be available with respect to the same investment transaction.

The basis of any qualified small business investment stock acquired under this provision would be its cost, reduced by the amount of gain not currently recognized. Ordinary income or capital gains realized from the sale or exchange of property could be deferred under Section 7.

Finally, the provision would provide for an extended statute of limitations for assessment of any deficiency arising from a failure to reinvest in a qualifying investment within the permitted time period.

This rollover provision would cost about $1.5 billion per year.

S. 842. The second bill, S. 842, involves tax incentives for small business participating debentures.

Present Law. Under present law, distributions of money or other property by a corporation with respect to its stock are not deductible by the corporation and are generally taxed as ordinary dividend income to the holder of the stock. Distributions by a corporation to a shareholder in redemption of his shares may qualify for capital gains treatment, but the corporation is not entitled to deduct any part of the redemption price. Interest paid or accrued with respect to indebtedness is deductible by the payor and ordinary income to the recipient.

There is uncertainty under present tax law regarding the proper classification -- as indebtedness or stock -- of instruments issued by corporations in cases where the instruments combine features of traditional debt with those of corporate stock. These instruments, known as "hybrid" instruments, may have a fixed maturity date and require certain fixed periodic payments labeled as "interest" (features common to traditional debt), but they also may grant to the holder an interest in the profits of the corporation (a feature typically associated with ownership of corporate stock). Some of these hybrid instruments may be treated as equity under present law, even though they purport to be debt, with the result that the tax treatment of the issuer and holder will be subject to the rules relating to payments with respect to stock. Hybrid instruments issued by unincorporated businesses present somewhat similar problems regarding whether they should be classified as indebtedness or equity in the issuing business.

Losses incurred by holders (other than certain financial institutions) on a sale or exchange of debts generally are capital losses. Losses from worthlessness of debts are ordinary losses, except that "nonbusiness" bad debts owed to individuals are short-term capital losses. Nonbusiness debts include debts made primarily with investment motives that are not made in connection with a trade or business of making investments or loans. Losses on the sale, exchange, or worthlessness of corporate stock generally are capital losses. One exception provides ordinary loss treatment for losses incurred by individuals on "section 1244 stock" issued by certain small business corporations, subject to a $50,000 per taxpayer annual limitation ($100,000 on a joint return).

Proposed Change. S. 842 would provide special rules for payments made with respect to "small business participating debentures" (SBPDs). An SBPD is a written "debt" instrument issued by any domestic trade or business (whether or not incorporated) having less than $10,000,000 of equity capital, no outstanding securities subject to certain securities law requirements, and no more than $1,000,000 of outstanding SBPDs, provided that the debt instrument satisfies 5 tests: (i) it is a general obligation of the issuer; (ii) it bears interest at a rate not less than the "test rate" prescribed for purposes of Code § 483 (presently 9% per annum); (iii) it has a fixed maturity; (iv) it has no voting or conversion rights; and (v) it provides for payment of a share of the total earnings of the issuer. The amount of the issuer's equity capital and outstanding SBPDs is to be determined by treating certain related corporations or businesses as a single entity.

A holder of an SBPD is required to report the interest paid on the obligation as ordinary income and is entitled to treat his share of the earnings of the issuer as long-term capital gain income. The issuer of an SBPD is entitled to deduct as "interest" all amounts paid to holders of SBPDs, including such amounts that qualify for capital gains treatment. Holders of SBPDs are not eligible for capital gain treatment if they own actually or constructively (under certain attribution rules) more than 10% of the value or the voting power of the stock (or equity) of the issuer (or a related business), or if the SBPDs are held by taxpayers who have reciprocal SBPD investments in each other.

Holders and issuers of SBPDs must treat the payment of a share of the issuer's earnings as having been made on the last day of a taxable year if the payment is made not later than the due date for filing the tax return for such year (plus extensions). SBPDs issued by noncorporate businesses (including individuals operating as sole proprietors) would be subject to the original issue discount and capital gain rules of Code § 1232 but not to the periodic interest inclusion rules of Code § 1232A. Losses suffered by holders of SBPDs would be eligible for ordinary loss treatment to the same extent as losses on "section 1244" stock issued by small business corporations.

The new provisions would be effective for SBPDs acquired after the date of enactment and for taxable years beginning after 1982, but do not apply to SBPDs issued before 1984 if the proceeds are used to retire loans other than certain specified types.

This proposal would result in an annual revenue loss of $3.5 billion by 1988.

S. 371. The third bill, S. 371, proposes amendments to the Targeted Jobs Tax Credit.

Present Law. A taxpayer who employs an individual who is a member of one of 10 targeted groups may elect to claim a tax credit equal to the sum of 50 percent of the qualified wages paid such individual during his first year of employment and 25 percent of the individual's qualified wages paid during his second year of employment. "Qualified wages" with respect to any employee may not exceed $6,000 per year.

Proposed change. S. 371 would increase the targeted jobs credit from 50% to 75% of qualified wages for "small business concerns" defined in § 3(a) of the Small Business Act.

The bill also would expand the list of targeted groups to include a "qualified unemployed individual." Generally, a "qualified unemployed individual" would be an individual who is certified by a designated local agency as (i) having been unemployed since January 1, 1982, and (ii) having exhausted all rights to unemployment compensation under any Federal or State law as of the week immediately preceeding the date he was first employed by the taxpayer. In addition, for an employer located in an area determined to have a rate of unemployment in excess of the national average, the bill would increase the credit from 50% to 65% of the qualified wages paid to a qualified unemployed individual who is a resident of that area.

S. 371 would apply to wages paid or incurred after the date of enactment in taxable years beginning after that date and before the close of the first calendar year in which the national unemployment rate is reduced to at least 6.5%. Its revenue cost would be almost $250 million per year.

Summary

The combined revenue cost of S. 1043, S. 842, and S. 371 totals more than $10.9 billion per year when fully effective. The magnitude of the revenue loss is particularly significant in light of current and projected budget deficits. Many of the proposals, if enacted, would generate pressure to extend the benefits to other businesses, vastly increasing the cost.

In addition to the revenue cost of these proposals, the Treasury Department believes that abuses could result in some cases. The provisions would make new distinctions among small businesses according to their organization, financing, or ownership. These distinctions would often be perceived as unfair. The Treasury also has serious reservations about the efficiency and potential effectiveness of these proposals in increasing capital to small businesses.

Current administration programs have reduced taxes for all forms of small businesses. These tax reductions are now in place and working. In view of the revenue cost of the proposals contained in the bills under consideration, and also in view of their potential unfairness and inefficiency, the Treasury Department recommends that these additional tax reductions for small businesses not be enacted.

Senator D'AMATO. The statement is 10 pages, and in the summary—as was really no surprise to this Senator—the Treasury Department opposes this legislation. Once again, taking—I think—an oversimplistic view that the revenue losses would amount to, if S. 1043, 842, and 371 were all passed, some $10.9 billion when fully effective, adding to the deficit. Of course, they will find out in their calculations there is absolutely no reflow—that means that there is no credit given to job stimulation, retention, addition, increased taxes generated from new and additional employment. And it takes the greatest revenue loss possible, and again, doesn't take in any revenue enhancers.

I find this rather difficult, because these are the same people who I think have done a magnificent job in lowering personal income tax rates, bringing about accelerated depreciation, correcting some of the long overdue overly restrictive tax policies. And yet, when it comes to going further and moving in the right direction to help make the economic recovery, job tax crediting, as Senator Sasser has put forth, to encourage people to bring into the job market other people, those are the kinds of things that are better than any Government make-work program where, in some cases, 50 to 60 percent of the money goes to the bureaucrats here in Washington and back home in local State agencies to administer the program, and the person out in the field doesn't get any real long-term job benefits, or job skills, et cetera. And at the end of the program the individual is let go.

But anyway, that is part of the record, and we really didn't expect much more.

Mr. Abrilz.

Mr. ABRILZ. Good morning, Senator D'Amato and Senator Sasser. I would like to include my testimony in full for the record. I will read about 3 or 4 minutes worth of it—well, probably more—of selected parts of the testimony. And then I can answer any questions if you have any.

My name is Santos T. Abrilz, Jr., and I am president and chairman of the board of APOCA Industries, Inc. APOCA Industries is a 9-year-old small business manufacturing telecommunications equipment with over 130 employees, located in Long Island, N.Y.

I also serve as vice chairman of the Long Island Area Economic Development Agency. Long Island has become the first suburban economic development district in the Nation.

And, I was elected to the White House Conference on Small Business as a delegate from New York, specializing in Federal procurement.

The Small Business Investment Incentive Act of 1980 directed the Securities and Exchange Commission to conduct an annual Government/business forum to review the current status of problems and programs relating to small business capital formation.

The first forum was held in Washington in September 1982, and was attended by approximately 200 small business persons and other interested individuals. Participants at the forum addressed issues in the areas of income taxation, securing credit from banks, access to financial institutions, and raising capital. Thirty-seven proposals were adopted by the forum.

These proposals and a final report of the forum were presented to Congress on December 1, 1982. One of the key tax reliefs requested by the small business was a reduction in the corporate tax rate. Another was incentive to invest in small business.

Senator D'Amato, S. 1043 addresses the fact that investment in small business must be stimulated so that the capital necessary to expand and create more jobs is made available.

Changing tax brackets will allow us to increase our retained earnings, which allows us funds for expansion. Our growth has always been inhibited by the fact that we cannot incur debt at a higher rate of interest when your cash flow, as it usually is for small business, is much less than is desired.

As we all are well aware, the market for securities is not the place where small business gets alternate financing. S. 1043 incorporates several changes such as increasing the capital gains deduction up to 80 percent from the present 60 percent for equity investments in small businesses. It inreases available investment capital for small business by deferring capital gains from property sales if the gains are reinvested in a qualified small business within 1 year and creating a 20-percent corporate maximum capital gains rate for small business equity investments. It benefits all business, therefore benefiting our country, since the need for jobs is the most pressing issue facing our country today.

Part of the solution of this problem lies in the ability to encourage the private sector investment in small business. The ability of small business to create new jobs and new markets is well known. A good example is the Inc. Magazine list of the 500 fastest-growing privately owned businesses in the United States. Between 1977 and 1981, these companies averaged a 571-percent increase in sales versus 70 percent for the Fortune 500. During the same period the group's work force grew 315 percent compared with 2 percent for the Fortune 500.

Our company was fortunate enough to rank No. 97 in the December 1982 survey of Inc. Magazine's list of the 500 fastest growing privately held businesses. And our own work force increased from 7 employees in 1977 to 130 today. We also rank 142 in Hispanic Business Magazine's June issue of 1983 in the top 400 Hispanic firms in the country.

A company belongs to a small business association in New England called SBANE.

On May 3 and 4, 1983, SBANE presented some issues at an annual meeting called the Small Business United Washington Presentation. One of these issues was the small business participating debenture.

America became great because of the foresight and courage of two very different segments of our economy. One was presented by the hard-working innovative entrepreneur and the other by his partner, the wealthy individual or financial institution that supplied funds for new and expanding enterprises.

Today we have plenty of small business owners who can fill the first role as well as ever, but unfortunately there are few financial risk takers who are willing to support their ventures.

The most common source of funds in the past has been commercial banks. But with the gradual disappearance of the small, locally

owned and managed bank, these funds have become less available. Large, structured banks are far less likely to finance closely held companies than were their owner-managed predecessors.

More and more of the Nation's wealth is being accumulated by insurance companies, pension benefit trusts, and other institutions. Regulations and traditional investment habits prevent these funds from directed toward risk situations. In fact, even low risk situations, if they involve small businesses, have a lack of acceptance in the institutional marketplace.

The motivation for an individual investor to direct his funds toward small business has virtually disappeared. If he wants to become a lender he would have to charge an incredibly high-interest rate to warrant the additional risk he would be taking compared to money market funds. Whatever interest rate he earns, however, will be subject to ordinary tax rates, and if the investment is bad, he will incur a capital loss, and have relatively little tax benefit to offset the economic loss.

On the other hand, should he turn to a purchase of equity, there is no way to realize either return of or return on the investment without either selling the holdings or being penalized by the prohibitive double tax on dividends.

There are a limited number of private venture capitalists. Those that do commit capital to emerging businesses traditionally finance only risk situations with a potential for extraordinary growth, not traditional expansion. In many instances, a substantial amount of equity and control must be given to the venture capitalists in order to secure this financing. We small businessmen of today find these conditions, for the most part, unacceptable. We believe that the Small Business Participating Debentures, which I will abbreviate to SBPDs, will finally provide the much-needed new source of capital for small businesses. It appears to solve many of the problems enumerated above.

An SBPD offers to the small business capital without giving up equity or having to tap existing sources of debt financing which, if available, are often unaffordable. For the investor, an SBPD offers a stated rate of return, plus a negotiated share of the profits, for a limited period of time. The approach should attract new investors because it will offer an opportunity to share in the profits of a potentially flourishing business.

For the entrepreneur, SBPDs will make available desperately needed funds for product development, market development, or, in my case, physical expansion. The typical small businessman will not mind generously sharing his profit as long as he or she knows that he or she is in control of his or her company and that there is a predetermined method for him or her to pay off his partner when his business can obtain conventional financing.

After almost 50 years of generating programs to deal with employees who are laid off, we still, in this wonderful country of ours, have not solved the unemployment crisis of the 1980's. The success of these programs has been severely limited due to the following factors: Limitation on the use of the job tax credit; lack of awareness on the part of most employers that credit programs exist; the implementation of the job tax credit involving complex tax rules.

There is a limited life to these programs. And finally, application of the jobs tax credit is to too narrow a group of employees.

The tax credit program is a powerful incentive for labor-intensive small businesses to create new jobs. It should incorporate some of the following: It should be used as an incentive for small business to invest in human assets rather than capital assets. It should act as an incentive for small business to increase the number of employees on a long-term basis rather than on a part-time or replacement basis. It should serve as an incentive to provide job training to unskilled or semiskilled persons. It should be easy to use. It should be easy to understand and publicize through mailings to our employers who pay payroll taxes. It should not need a long certification program. It should be based upon new hires rather than upon types of employees hired. It should be administered by IRS through reporting on income tax returns.

Any jobs credit program would provide an incentive for small business to hire new employees at a quicker pace. This would result in removing people from the unemployment sector to the tax-paying section, resulting in a positive rather than negative impact on the U.S. Treasury.

Today's tax laws provide very generous incentives to corporations that invest heavily in capital assets. But these same tax laws have very little incentive for corporations to invest in human resources. The time has come to balance this out.

To close on a personal note, I note that today's date is July 13. It is also the birthday of my 22-year-old son, Santos D. Abrilz III, who is currently serving in the U.S. Navy.

Thank you, Senators.

Senator D'AMATO. Thank you very much, Mr. Abrilz. Happy birthday to your son.

Mr. Bateman.

Mr. BATEMAN. I also have a prepared testimony which I have submitted. But I am not going to use that, if that is all right with you.

Senator D'AMATO. However, your testimony will be entered into the testimony as if read in its entirety.

Mr. BATEMAN. All right; fine. Thank you.

And I would like to give you the opportunity to ask me a lot of questions, too. I am really honored to be here. It was an unexpected honor, and I hope I can get some ideas across to you that might be a little bit different than what you have heard before. My prepared testimony had much the same as they had to say about the benefits of the three bills that we have before us here. And I am in favor of all three of the bills. I am in favor of all three of the bills because they will do nothing but help the small business sector of our economy. They can't hurt the small business sector of our economy.

I want to speak specifically, first, about this 371, Senator Sasser's bill, because my clients are all very small businesses. I haven't been in business that many years myself. And all of our businesses happen to be labor-intensive businesses. And salaries and wages are the primary expense of those companies.

I went to the trouble to look back to 1977 when we had the general jobs tax credit available to us. I thought well, I will just see

what did it do then. I flipped back through the files and I discovered that there was approximately 25 new jobs created out of my clients. And in 1977 we had only been in business a couple of years, so I have a small client base to draw from. But 25 new jobs were created through this tax incentive, this tax credit.

One of the questions that came to my mind when I did this research was—well, was the tail wagging the dog or was the dog wagging the tail? And approximately 1 percent of those jobs, because my clients knew that the credit was available, it encouraged them to speed up the hiring of those employees. Is that an incentive? I think it is. I think it worked well in their case. They would have hired these employees anyway, because their companies were growing, but it was that little added spark, that little added incentive to go out and look for those people at that time, and the bill as we have right now is an expansion of the current targeted jobs tax credit, which currently is just—it draws on too narrow a job market.

The bill, as Senator Sasser proposes, broadens the market that my clients can draw from.

I can see this as an incentive myself. We have been hashing around hiring a new employee, too. And a savings of $3,000 to $4,000 on wages is a strong incentive to go ahead and hire this employee today instead of waiting for another year to hire this employee.

You know, when these gentlemen and myself went into business, one of the partners that we took on was Government. And, you know, Government is a very demanding partner. He helps us to decide what kind of accounting methods we are going to use, he decides what kind of recordkeeping we are going to have. We have to report to him on a timely basis. And on top of that he wants to share in our profits, too.

I understand the necessity of all of this. But the problem with all this is if the entity was a human, the first thing they would want to know is, well, where is your investment in my business? Well, 371, 842, and 1043—in my opinion—is an investment in these businesses.

Going back to Senator Sasser's bill, and then the comment that you made awhile ago about the Treasury Department sending over a prepared statement, you said they left out some vital information.

If you can provide the incentive for one employee to be hired, you have taken somebody off an unemployment roll somewhere, under the provisions of the Senator's bill. And you have replaced him as a taxpaying citizen. I don't see how that could cost the Government anything, because if it is not used they are not out any more money; but if it is used they are ahead, they have increased the tax base, they have got a new taxpayer, and obviously new tax revenues will be generated.

Senator D'AMATO. It is pretty hard to understand why it is that if we give a tax cut to people, to individuals—and I favor that cut, fought for it and fought to retain it in the third year as well, because I think that will probably be the first real cut, tax benefit, that people will receive, given the fact that we had inflation, and given the fact that the social security tax ate up all of the other

taxes but the last 10 percent. But if the idea is to say that if we give people the ability to retain more they then can save more, they then can purchase, they will do the kinds of things that will move the economy, why is it that in the small business community in particular that that same set of facts is not applicable, that if I give increased tax benefits to the small business entrepreneur in particular, at the corporate level, for investment purposes, capital gains purposes, et cetera, capital formation, where we say you have to own and retain for 5 years. We put in some limitations here. Why is that not going to be the case as well, and maybe even more so when we are talking about people who are in the business of needing capital to invest to expand, and to modernize if they are going to compete successfully in the high-tech area. That takes money; it takes capital.

So why is it that that wouldn't be the principle in the long run instead of the Treasury losing funds? We argued for the personal tax cut and the business tax cuts.

What would you say to that, Mr. Bateman?

Mr. BATEMAN. Well, my feeling is, from my experience, any savings generated by my clients in their businesses, and I am talking about in general; in specific cases this is not true. But in 99 percent of the cases, any earnings that a company is able to retain goes into their business, because what surrounds their life? It is their business.

In my prepared statement I mention the fact that I get involved in family-related business problems, because going into business for yourself is a trauma that goes down to your family, too. So he is not interested in losing that or seeing it decrease. He is interested in seeing it grow and expand. So any revenues that are able to be retained will go back into that business, which, in turn, will generate more income, more profits, more taxes, more jobs. It will create more efficient production. Because my clients have to be cost-efficient, because no one of them has such a monopoly on the market that he can charge anything that he wants. So he has to be productive with what he does.

Senator D'AMATO. At this point I am going to ask my colleague, Senator Sasser—I know he has some questions of you and of some of the other panelists. I am going to give him that opportunity, because we are all under heavy time constraints.

Senator Sasser.

Senator SASSER. Well, thank you, Mr. Chairman.

With regard to the reflow of funding that comes from increased employment, I have found through my work on the Senate Budget Committee that it is generally conceded that every 1 percent of unemployment in the economy of the Nation, which translates to about 1.1 million workers, costs the Federal Government in the neighborhood of $25 to $30 billion. That is for every 1 percent. So you can very quickly see what happens to the Federal budget when your unemployment rate jumps 3 percent. Very quickly you build up a $75 to $90 billion increased deficit, depending on whose numbers you are using.

Mr. Stoner referred a moment ago to the problem of the Federal deficit and the dangers of increased interest rates that might flow therefrom. There are other reasons for increased interest rates, not

the least of which some of us believe to be overly restrictive monetary policies on the part of the Federal Reserve Board.

As an aside, this afternoon Chairman Paul Volcker is coming in to see me in preparation for his confirmation hearings tomorrow before the Senate Banking Committee, on which Senator D'Amato and I both serve. And I just wondered if this distinguished panel of small business people here and those associated with small business might wish to volunteer a few questions or observations that I might propound to Mr. Volcker this afternoon. [Laughter.]

Mr. STONER. I think it would be very presumptuous of myself to make any questions to such a learned person as he in his area. But there is certainly no question about it. As I mentioned in my testimony, we cannot—it is intolerable if we go back to those rates for the small business community in their dependence on bank loans.

So I am sure you can't ask the chairman what his guarantees will be about anything, but I would certainly work him over pretty decently on the whole subject of interest rates.

Mr. ABRILZ. As a manufacturer on Long Island, if I were to try to expand, which I am going to have to do in about a year to a new facility—we have 130 and we are thinking of having another 80 employees coming on in the next 12 months. If we were to even think of a 20-, 21-, or 22-percent interest rate, not only would we not be able to hire more employees, but I doubt very seriously that we could remain in business.

Mr. BATEMAN. Even the higher interest rates—my business clients are very small. The largest employer has about 60 employees. Coupled with the high interest rates is just the degree of difficulty that the small businessman has in obtaining a loan. And when you come around with the high interest rates that we have experienced in the past, it is just a crushing blow; it is just a burden too heavy for them to bear anyway. So that's an important point.

Senator SASSER. Let me ask this question. Following on interest rates, if you will allow me to digress for just a moment, Mr. Chairman, and pursue this line of questioning. I feel very strongly that the problem of high interest rates has had a devastating effect on the small business economy of this country over the past 2½ to 3 or 4 years.

I might ask the panel what is their opinion with regard to the reasonableness of interest rates now. Is it your feeling that the rates are still too high? At what interest rate level do you think that we could see rapid expansion of small business?

That is a two-pronged question. Do you think they are still too high? I suspect the answer to that is going to be yes. And at what level do you think we could see some real expansion in small business in this country?

Mr. STONER. Well, as you so surmised, the answer is, of course, they are still too high. And I guess the only thing I could comment on is that any degree of lowering of those interest rates is going to make a particular entity of business more profitable and capable of a person to go into it. I don't think there is any one number that you could point at and say, aha, we have now got a panacea and we have arrived. But I believe the lower they go—obviously you are going to get a sliding scale of more businesses which become feasi-

ble and practical and with potential profit. And therefore, as they go down, the business community will expand on a reverse basis.

Senator SASSER. Mr. Bateman, let me ask you this in your experience as an accountant. If we could get interest rates down once again, say to the range of 8.5 percent to your clients, to me that seems to be very realistic. After all, over the past 60 or 70 years in this country, interest rates have run at the rate of between 1.5 to 3 percent ahead of the rate of inflation. Well, today as we sit here they are running 7, 8, 9 percent ahead of the rate of inflation.

So if we could reduce them, in nominal terms, to 8.5 percent, what impact would that have on your business clients in your judgment?

Mr. BATEMAN. It would have a significant impact. Because, if our clients saw the interest rates at that level, it would do something else. It would generate a confidence in their outlook on their business future.

My clients probably would be willing to pay the interest rates that are available now. But one of the problems they have is that they are afraid to look 6 months, 12 months, 24 months down the road to decide well, am I going to be able to afford it at that point in time. Sure, an 8.5-percent interest would stimulate the economy, because I think it would also indicate confidence in the recovery that seems to be starting.

Senator SASSER. Well, I couldn't agree with you more, and our chairman, Senator D'Amato, has done excellent and splendid work for the legislation that he has proposed. And I want to commend him for holding these hearings here this morning. They are very helpful and I think they are very meaningful. And I am, I hope, justifiably proud of the legislation which I am sponsoring here.

But occasionally I still come away with a feeling that we are just working around the edges here, and what we really have got to get to is to make our legislation totally meaningful by doing something about bringing down the cost of capital for small business and bringing down interest rates for small business.

Mr. Bateman, there have been some fears expressed about the use of target groups for tax credit purposes. It has been argued that narrowly defining groups may actually be counterproductive if these groups are only a small portion of the labor force. And it could be very costly for employers—small business employers particularly—to try to seek out these small groups.

Some say the targeting of groups or individuals for the purposes of tax credits can tend to stigmatize such persons, making employers less willing to hire them, even though they do get the tax incentives.

Frankly, there is some merit to these assertions, I believe. But I also feel that we have a responsibility to protect and assist those members in our society who are most in need of aid.

So we have tried to strike a balance in S. 371 by creating a target group that is somewhat removed from the narrow definitions, but at the same time addresses the needs of what we consider to be worthy segments of our society.

So my question to you, Mr. Bateman, is, do you feel that this bill effectively addresses some of the concerns that we hear raised over too narrowly defining the target groups?

Mr. BATEMAN. Yes, I do. And I say that because the targeted jobs credit that we currently have has narrowed that working sector to such a small portion of the labor force that a lot of my clients feel uncomfortable drawing from that market.

You have not excluded them from this jobs credit, but added to the pool. And I think, if anything, it would be an added incentive to draw from the pool, which would also include the people that are currently targeted for these types of job credits.

Senator SASSER. Well, not everyone shares the view that jobs tax credits are the fastest and most effective method of stimulating employment. It may not be the most effective, but it is the most effective that we can come up with at the moment. And some feel that jobs tax credits do not offer sufficient rewards to prompt firms to hire new employees.

I have attempted to address this concern in S. 371 by increasing the amount of credit available to 75 percent of qualified first-year wages where the employing firm is a small business.

I feel that this raises the amount of the credit to a sufficient level to impact the hiring practices of small firms. That is my view.

And I suppose my question to you, Mr. Bateman, and any of the others who would wish to comment—you are down where the rubber meets the road. Is this a sufficient inducement to encourage small business to go out and hire people?

Mr. BATEMAN. It is an inducement. As I said earlier, my experience with the previous jobs credit—there were approximately 16 out of 25 new jobs that were created or started early simply because the credit was available and known to my clients, because I have a high degree of responsibility to make them aware of these types of things.

So, yes, the incentive for them to hire was generated by the credit. You asked me if it is large enough. I think it is large enough. We are talking about a $4,000 reduction in wages, and that is a significant reduction in any of my clients' employees' wages.

So I think that numerically and from a dollar standpoint that, yes, it is sufficient.

Senator SASSER. Do you wish to comment on that, Mr. Abrilz?

Mr. ABRILZ. Yes. It is not as simple as just a tax deduction. When you target a group of people who traditionally have not had the education or the wherewithal to be able to come into a place of business, fill out an application, understand the work rules and habits, et cetera— I guess I am condemning, but I am condemning the educational system of today.

We are getting employees who can't read a——

Senator SASSER. You've got a lot of company on that condemnation I would say.

Mr. ABRILZ [continuing]. And can't write, but these people have expectations based on what they see around them. And they expect to earn a salary, et cetera. Yet they are not capable, and they have to be trained. So the training process is not a short process, because they have to be trained to do practically everything. And I think that your provision of the $4,000 is a tremendous incentive to set aside a training program where you can properly do the training and then bring them into the work force. You can't bring somebody into the work force from day one and have them perform. All

you are going to do is increase rejects. But if you can train them and then shove them over into the work force, then you have got yourself a person who is much more capable of lasting long enough to get the diploma that says you graduated from whatever training program you gave them.

Senator SASSER. Good point, and very well made, I think.

Mr. STONER. The only comment I would wish to add to that is that a lot of times small businessmen have a very difficult time projecting their future businesses and their product opportunities and the market opportunities. They are usually doing it over a longer period of time than 1 year.

Incentives which benefit a firm for 1 year by a particular employee being hired are certainly of an advantage to do that. I perhaps might opt for a program which gave longer-term benefits to the particular action taken, so that the businessman can blend his product opportunities and market opportunities and costs which could then be proje.cted into a future of what he might realistically believe could happen.

Senator SASSER. If you could have it, would you rather have a lower tax credit over a longer period of time?

Mr. STONER. In my particular business where we talk about——

Senator SASSER. If you had to make the choice——

Mr. STONER [continuing]. Two, three, four years in the future, with the products and the developments we were doing, yes, that would be more beneficial.

Senator SASSER. All right.

Mr. Chairman, you have been very kind to yield me this time. I might say this in passing. I asked this distinguished panel for their advice on what to say to Mr. Volker. And one of the things that is very much on my mind, as you can see, and one of the things I am going to tell the Chairman is that in my view it is time that we went back to the days prior to the spring of 1979 when he became Chairman of the Federal Reserve Board. And I can say this in a bipartisan way, Mr. Chairman, because he was appointed by a president that I supported and reappointed by a President that you support.

But it is time that we back away from this fixation on money supply and move back to the prespring of 1979 days when one of the functions of the Fed, we all thought, was to try to guarantee interest rates that would allow American business to expand and to prosper. And if this panel has no objection, I am going to tell him that I mentioned that to three very distinguished small business people, and they didn't disagree with me on it.

Thank you.

Senator D'AMATO. Thank you, Senator Sasser.

Mr. Stoner, obviously you are aware of the fact that Buffalo has had its difficulties in terms of employment, facilities closing down, particularly older ones. If you had 1043 in place, which would provide for lower tax rates, would that be used by the small businessman or corporate executive for job retention and investment in the plant and equipment, et cetera? Or would it just give him a greater take-home pay? That is really the question. Is it going to be money that he takes home or money that you see being invested in his business?

Mr. STONER. I believe Mr. Bateman commented, and I totally endorse his comment, that the average small business person is into his business lock, stock, and barrel. It is his life; it is his whole being. It is his family's being. Therefore, when he has a dollar of profit from his business, my estimate is that that is going to be invested in his business, and he is not the type of person to get up and run to Florida just because he has an extra $10 in his pocket. He will invest it, and he will invest it in his business. And my great suspicion is that given the market opportunities, he will invest it locally in our area.

Senator D'AMATO. Mr. Abrilz, would you care to comment on that?

Mr. ABRILZ. Basically I have to agree with him. People have the tendency to think of us as 9-to-5 people, and really we are 22-hour-day people, no matter how small or how big you are.

The one thing you realize as you grow is that your sense of responsibility grows to the number of people who are working for you. You start out for yourself, and if you get past the 100 employee barrier you realize that there are a lot of people out there depending on you. And then your decisions become more critical. You don't jump the gun like you used to and fly by the seat of the pants. You do go into planning, and sooner or later become a big business. That is the way it becomes. You have no choice as a manufacturer; you grow or you die.

I feel that too much time has been spent on "ma and pa" shop types of small businesses. It is time this country realized that the only businesses that are going to create and become the future Hewlitt Packards and IBM's of tomorrow are manufacturers, are services, but are not the 4- or 5- or 10-man shops. I know I disagree with some parts of small business when I say that. But the 4-, 5-, 10-man shops will always exist in this country. There is always a market for them. But the 100- to 500-man shops, they are the ones that can't go out and get the money at the rates of today. They are the ones that an increase in social security tax is a devastating blow on the profits of that corporation, which means that they will hire less employees for the coming year.

So I think what is needed is another round of meetings where small business people come to Government and say hey, look, 2 years, 3 years have gone by. These are our problems of today. Because what happened in 1980 just doesn't compare to what has happened in the past 3 years.

So I agree with what Mr. Stoner said with respect to the comment on capital formation.

Senator D'AMATO. Of course, Mr. Bateman, you have testified exactly on that same point.

Let me ask you something in terms of our provisions with respect to encouraging investment by way of S. 842, the Small Business Participation Debenture Act. Mr. Bateman, do you think that has any opportunity of encouraging capital formation in that manner rather than a traditional manner of going to the bank? Do you see that as a way of raising capital?

Mr. BATEMAN. Yes, I do. I know of several people, several instances where there have been investors wanting to put money into a business but the owner of the business, as we talked about earli-

er, is so proud of his business that he doesn't want to give up ownership. This is an alternative.

The thing that I like about it in particular is what happens to the earnings participation. Talk about the order of payment: First repayment made on the debenture will be treated as interest, and then any earnings participation beyond that is to be treated as long-term capital gains. Well, that has a lot of significance to me because I can tell my client or the potential investor, he can afford to earn less.

Senator D'AMATO. The small business community, will they have the sophistication to grasp that in terms of capital formation?

Mr. BATEMAN. I would hope so. I would hope that they would come to me and ask me about it. [Laughter.]

This would be the type of thing that not only I, but just any CPA or accountant or adviser would be knowledgeable of, because somebody would have to prepare documents, and whoever prepares documents should have the expertise or the knowledge.

Senator D'AMATO. You sound quite enthusiastic about it.

Mr. BATEMAN. Oh, I am. I am very enthusiastic about it.

Senator D'AMATO. Mr. Stoner, as someone who, again, has been in an area hard hit during the economic recession and depression in western New York, and someone who has just talked to the issue of the interest rates still being at levels that cannot sustain the type of capital investment necessary to really get our production going and get better employment figures, what is your view on S. 842 and its potential for being a mechanism for cheaper capital?

Mr. STONER. I like it a lot. Anything that is going to stimulate capital into the small business segment of our economy is going to benefit it in total and certainly is going to benefit western New York.

Senator D'AMATO. Would you be able to turn to it? Would you turn to it yourself as an entrepreneur?

Mr. STONER. As an entrepreneur, I—as I stated earlier there is no reason for me to look to the small business segment of the economy as a place to invest today, unless I see an extremely unusual market opportunity. And with this kind of a vehicle I would be the first in line to be forming some kind of an organization to take advantage of this.

One thing, the Buffalo News right now has been running a series of articles. One thing that might be addressed is that if the money was raised in the Buffalo area—I realize this is not a Federal issue—but the State might want to come in on saying that those moneys—a proportion of it—would be invested in their own hometown or backyard economies, rather than sending it to the southwest. With that provision it would certainly be a great benefit to the western New York economy.

Senator D'AMATO. Mr. Abrilz.

Mr. ABRILZ. As a manufacturer who wants to expand and get a new building in 2 years I would definitely be interested. For the simple reason that—what seems to be forgotten is that a lot of companies are not public. They are not on the American Stock Exchange; they are not over-the-counter. And the only financing method we have is through the bank at inordinately high interest rates. Or through participation in a program like this. There are a

lot of people who wouldn't hesitate to invest money in my company and other companies like mine on a short-term basis; pull out with profits, et cetera. I think it is a tremendously good vehicle.

Senator D'AMATO. Your plant is now in Deer Park?

Mr. ABRILZ. Yes, on Long Island. And we are too small; we need more room.

Senator D'AMATO. Where will you be expanding? East or west?

Mr. ABRILZ. Somewhere between Islip, Smithtown, Babylon—somewhere in there.

Senator D'AMATO. Oh, I thought we could get you more into Nassau. [Laughter.]

Mr. ABRILZ. If you fix Route 110 and the Long Island Expressway, maybe we will think about it.

Senator D'AMATO. You mean if I get the Long Island Expressway and put it into the Federal interstate, then you might think about it?

Mr. ABRILZ. Then my employees would have a chance to get to and from work in less than an hour rather than the 3 hours it now takes.

Senator D'AMATO. I'll have to look into it.

Let me thank this panel for your testimony and for your time. And as those who are on the frontlines, who can give your expertise as to what you have been through, what you see, and what the potential these bills may or may not have. Obviously it is going to be tough going, but maybe if we continue we will be able to get some of these bills enacted.

Thank you very much.

[The prepared statements of Mr. Stoner, Mr. Abrilz, and Mr. Bateman follow:]

STATEMENT BY ROBERT STONER
EXECUTIVE VICE PRESIDENT
WINFIELD INDUSTRIES, INC.
33 Clarence Avenue
Buffalo, New York
BEFORE SUBCOMMITTEE ON URBAN & RURAL ECONOMIC DEVELOPMENT
SENATE SMALL BUSINESS COMMITTEE
JULY 13, 1983

Senator D'Amato and other distinguished members of the Senate Subcommittee on Urban and Rural Economic Development, I appreciate the opportunity provided to me to participate in this hearing concerning recommendations of the Securities and Exchange Commission's Forum Report on Small Business Capital Formation and subsequent legislation introduced as a result of these recommendations.

My name is Robert Stoner and I am Executive Vice President of Winfield Industries, Inc., a small manufacturing firm located in Buffalo, New York. Previous to this position, I was the owner and President of Winfield, having sold it to another individual entrepreneur within the past year. In addition, I am Chairman of the Council of Small Business Enterprises, a Chamber of Commerce related organization serving approximately 2,000 small businesses in our area. I also am privileged to be a member of the New York State Governor's Small Business Advisory Board.

From both business experiences and exposure to many small business persons and issues, I am totally aware of the restraints placed upon many small business start-ups and expansions by difficulties in obtaining sufficient capital. It is well documented and need not be dwelled upon here that the small business person's major sources for capital today are owner and family equity, retained earnings and commercial bank loans. The first two of these sources are usually limited in amount and in recent years the third has become very expensive and in some cases impossible to obtain. Increasing and/or making less costly funds available to small business will certainly accelerate job formation in a segment of our economy which has proven its ability to do just that.

In 1980 at the White House Conference on Small Business (at which I had the honor of being Congressman Nowak's appointed delegate), the delegates arrived at an early consistency of views, expressing their concern about capital retention by recommending more graduated tax rate scales up to $500,000 for corporations and for a simplified accelerated capital recovery system. Corporation rates were cut and there was some improvement in accelerated depreciation schedules, but more must be done.

Subsequent to that conference, at a time when interest rates and inflation continued to rise, small businesses suffered disproportionately to their numbers because of their traditional dependence on bank loans as their prime source of capital and because of their inability in many instances to pass through inflationary cost increases to customers because of the typical competitive structure of their businesses. As a result, bankruptcies reached levels of the 1930's, with many contributed to by the unprecedented cost of loans which were made even larger because of the aforementioned inflationary forces.

Now that inflation has abated, the prime has come down and the recession appears to be moderating, it is imperitive that we not forget the bitter lessons of the past few years. You are to be congratulated for calling for the Securities and Exchange Commission's Forum on Small Business Capital Formation and for putting a portion of their recommendations into proposed legislation.

Regarding the specific proposals of Senate Bill 1043, I do not consider myself an expert in the area of taxation and its impact upon the various segments of our economy, however, as one deeply involved in small business both personally and as a spokesman, I will offer my considered views.

As one who owned and ran an expanding manufacturing small business for about 12 years I can, without hesitation, say that our growth, and along with that job creation, would have been accelerated if more capital had been readily available. During my early business ownership years, a buy out agreement with previous owners prevented my obtaining loans from any source, and the majority of my after tax earnings were pledged to retire the buy out indebtedness. This meant that for all practical purposes no investments in equipment or facilities occurred during this period. Under the rate you propose in Senate Bill S1043, retention of additional capital would have allowed me to complete the aforementioned buy out in approximately six years, instead of the seven actually taken and would have therefore created an ability to invest funds in the business that much sooner. Once the buy out obligations were satisfied and until the company was sold last year, a period of three years, all after tax profits were left in and invested in the business. A larger share of profits retained in the business would have resulted in faster expansion since, at the time when this occurred, interest rates were beginning to increase dramatically, and as a result I essentially eliminated loans as a potential source of capital. In other words, I limited expansion to that permitted by, after tax retained earnings rather than incur the hight cost of borrowed money.

Section five of your proposed legislation calling for a cash versus accrual method of accounting for certain small businesses appears similarly justified on the merits of equality. Small businesses with significant inventories would not have to face the prospect of getting expensive loans to pay income taxes resulting from these inventories. Why should the very small business person be forced to pay taxes with monies he may not have received? Common justice would prevent this from happening. In addition, and with apologies to my friends in the accounting profession, the truly small business person would be saved outside accounting fees of a significant amount if his accounting methods were legally simplified.

Retained capital, in my opinion, is the single most important source of capital for the existing small business enterprise. Section two and five, if enacted into law, will add to this valuable source. As much as I will endorse and advocate other sections of your tax proposals later in this testimony, these sections on greater retained earnings are my number one priority. You can be virtually guaranteed that the typical business owner will invest his after tax earnings in his business assuming, of course, that his market opportunity is such that it is prudent for him to do so. It follows that this additional investment will create an expended business and with it additional jobs.

Concerning the sections of your legislation which address the increases in the capital gains exemption, offer a 10% tax credit for small business investments and permit the capital gains roll-over without tax, I can only applaud your proposals. For those investors willing to put equity capital into new ventures, there should be an increased capital gains deduction over the curren. deduction of 60%. This larger capital gains deduction would give a greater reward for those people willing to invest in small businesses, a reward which would compensate better for the potential risks involved in such ventures. Statistics showing the high degree of small business failures demand higher reward opportunities for the investor if investment capital is to flow in their direction. It is certainly a greater risk to invest in new small business ventures as compared to investments in such largely held stocks as General Motors, IBM, etc., and therefore, the rewards should be greater. Similarly, an immediate 10% investment tax credit would stimulate more investments in small business by certain individuals and allow the investor some current tax benefits for his investment.

Finally, I agree that the tax law should be changed to provide a deferral of taxation if an investor reinvests his capital within a certain time period in another small business venture. This would mean that there would be more capital available to invest in new ventures, rather than it going into tax coffers.

These proposals of S1043, sections 3, 4, 6 and 7, taken together should stimulate the flow of venture capital to the high risk start-up business and are a good companion to your proposals on increased retained earnings under sections 2 and 5.

In this regard, let's look at my own situation. (I don't consider my own business experience anything unusual or unique). Upon the sale of my business last year, I became immediately subject to a net capital gains tax of about 20%. Of the remaining amount, I have invested primarily in quality stocks of major U. S. corporations, tax free Municipal bonds and U. S. Treasury Notes. This could be considered an ultra conservative stance and a complete reversal of my previous high risk business experience. My capital has been moved from the Small Business entrepreneurial segment of our economy to the large business and government segment of our economy. The simple reason for this is that there is no tax incentive for me to do otherwise. In fact, through municipal bond ownership there are tax incentives to encourage just such a move. What incentive is there for me to leave my capital in a high risk area under today's tax codes? I am afraid that the answer is that there is none. Your proposal to bring risk versus reward more into balance would certainly correct this problem. Until I can see after-tax profit potentials greater than those obtained by more conservative investments, my capital will not move.

In total, the provisions of your bill, if carried into law, would have a compounding effect for small businesses. States with tax coupling laws already in place, and those without, will follow your lead and implement similar changes in their tax codes, benefiting the small business segments of their individual economies. You will, therefore, get added impact from what you propose.

Beyond the immediate goal of increasing job formation, which is reason enough for your reforms to our tax code, I would also like to believe that your proposals direct themselves to a higher purpose..

Small Business is well known to be the bastion of the competitive free enterprise segment of our economy. As small business prospers, so will the entrepreneurial spirit that has carried our country so far in such a short period of time. Your efforts may very well help to preserve this great system of ours so that your children and mine can enjoy the blessings of freedom and the privilege to prosper, or fail, as one might so choose to do. Obviously, no single action or bill will solve all of our future problems; the actions you propose, however, are certainly a step in the right direction and appear to be well directed towards the future health

and survival of small business and indeed our free enterprise system. As a consequence, I believe that as free and competitive enterprises survive and prosper, personal freedom will also survive and flourish.

In summation, I could not speak more enthusiastically about the merits of your proposed bill, but with one precautionary note. Most small business persons I speak to are seriously concerned with the current taxing and spending levels of our Federal Government which are going to create large deficits under the budget proposals now passed by Congress. Their legitimate fear is that interest rates and inflation will again return to the heights of the past two years and result in another round of interest cost generated bankruptcies, as well as general inflationary distortions in the economy. Most small business persons I know would give up tax benefits to themselves of the type you propose in your legislation, if they could be assured of an economically stable future in which to operate their business. They would sacrifice their benefits if other economic entities impacting upon this problem could similarly sacrifice theirs, generating confidence in the future. Even if the legislation you proposed were entirely passed as now written, commercial bank loans will probably still be the single most important source of capital for the small business person. To allow interest levels to return to previous highs or even higher, is a totally unacceptable prospect and small business will correctly hold the Federal Government and those who run it, responsible if this should occur.

Thank you again Mr. Chairman and subcommittee members for the opportunity to speak before you. I wish you well in your efforts on behalf of small business and stand ready to be of whatever further assistance you might desire.

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STATEMENT BY SANTOS T. ABRILZ, JR.
PRESIDENT AND CHAIRMAN OF THE BOARD
APOCA INDUSTRIES, INC.
10 CONNOR LANE
DEER PARK, LONG ISLAND, NEW YORK 11729

BEFORE THE SUBCOMMITTEE ON URBAN AND RURAL ECONOMIC DEVELOPMENT

SENATE SMALL BUSINESS COMMITTEE

GOOD MORNING,

MY NAME IS SANTOS T. ABRILZ, JR. AND I AM PRESIDENT AND CHAIRMAN OF THE BOARD OF APOCA INDUSTRIES, INC. APOCA INDUSTRIES IS A 9 YEAR OLD SMALL BUSINESS MANUFACTURING TELECOMMUNICATIONS EQUIPMENT WITH OVER 130 EMPLOYEES LOCATED IN LONG ISLAND, NEW YORK.

I ALSO SERVE AS VICE-CHAIRMAN OF THE LONG ISLAND AREA ECONOMIC DEVELOPMENT AGENCY. LONG ISLAND HAS BECOME THE FIRST SUBURBAN ECONOMIC DEVELOPMENT DISTRICT IN THIS COUNTRY.

MY TESTIMONY THIS MORING WILL BE ON THREE VITAL ISSUES TO THE SMALL BUSINESS COMMUNITY DELIVEATED BY THE FOLLOWING BILLS:

1) S1043 - SMALL BUSINESS CAPITAL FORMATION TAX ACT.

2) S371 - TARGETED JOBS TAX CREDIT AMENDMENTS ACT OF 1983.

3) S842 - TAX INCENTIVES FOR THE ISSUANCE OF SMALL BUSINESS PARTICIPATING DEBENTURES.

THE SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1980 DIRECTED THE SECURITIES AND EXCHANGE COMMISSION TO CONDUCT AN ANNUAL GOVERNMENT BUSINESS FORUM TO REVIEW THE CURRENT STATUS OF PROBLEMS AND PROGRAMS RELATING TO SMALL BUSINESS CAPITAL FORMATION. THE FIRST FORUM WAS HELD IN WASHINGTON IN SEPTEMBER 1982 AND WAS ATTENDED BY APPROXIMATELY 200 SMALL BUSINESS PERSONS AND OTHER INTERESTED INDIVIDUALS. THE PARTICIPANTS AT THE FORUM ADDRESSED ISSUES IN THE AREA'S OF INCOME TAXATION, SECURING CREDIT FROM BANKS, ACCESS TO FINANCIAL INSTITUTIONS, AND RAISING CAPITAL.

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THIRTY SEVEN PROPOSALS WERE ADAPTED BY THE FORUM.
THESE PROPOSALS AND THE FINAL REPORT OF THE FORUM WERE PRESENTED TO CONGRESS ON DECEMBER 1, 1982. ONE OF THE KEY TAX RELIEFS REQUESTED BY THE SMALL BUSINESS WAS A REDUCTION IN CORPORATE TAX RATES.
ANOTHER WAS INCENTIVES TO INVEST IN SMALL BUSINESS.
S1043 ADDRESSES THE FACT THAT INVESTMENT IN SMALL BUSINESS MUST BE STIMULATED SO THAT THE CAPITAL NECESSARY TO EXPAND AND CREATE MORE JOBS IS MADE AVAILABLE. CHANGING TAX BRACKETS WILL ALOW US TO INCREASE OUR RETAINED EARNINGS WHICH ALLOWS US FUNDS FOR EXPANSION.
OUR GROWTH HAS ALWAYS BEEN INHABITED BY THE FACT THAT WE CANNOT INCUR DEBT AT A HIGHER RATE OF INTEREST WHEN YOUR CASH FLOW AS IT USUALLY IS FOR A SMALL BUSINESS IS MUCH LESS THEN DESIRED.
AS WE ARE ALL WELL AWARE, THE MARKET FOR SECURITIES IS NOT THE PLACE WHERE SMALL BUSINESSES FOR ALTERNATE FINANCING.
S1043 INCORPORATE SEVERAL CHANGES SUCH AS INCREASING THE CAPITAL GAIN DEDUCTION UP TO 80% FROM THE PRESENT 60% FOR EQUITY INVESTMENTS IN SMALL BUSINESSES, INCREASING AVAILABLE INVESTMENT CAPITAL FOR SMALL BUSINESS BY DEFERRING CAPITAL GAINS FROM PROPERTY SALES IF THE GAINS ARE REINVESTED IN A QUALIFIED SMALL BUSINESS WITHIN ONE YEAR AND CREATING A 20% MAXIMUM CORPORATE CAPITAL GAINS RATE FOR SMALL BUSINESS EQUITY INVESTMENTS ITS BENEFITS ALL BUSINESS THEREFORE BENEFITING OUR COUNTRY SINCE THE NEED FOR JOBS IS THE MOST PRESSING ISSUE FACING OUR COUNTRY TODAY.
PART OF THE SOLUTION TO THIS PROBLEM LIES IN THE ABILITY TO ENCOURAGE PRIVATE SECTOR INVESTMENT IN SMALL BUSINESS. THE ABILITY OF SMALL BUSINESS TO CREATE JOBS AND NEW MARKETS IS WELL KNOWN. A GOOD EXAMPLE IS THE INC MAGAZINE LIST OF THE 500 FASTEST GROWING PRIVATELY OWNED BUSINESSES IN THE U.S. DURING

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1977-81, THESE COMPANIES AVERAGED A 571% INCREASE IN SALES VERSUS 70% FOR THE FORTUNE 500. DURING THE SAME PERIOD, THE GROUP'S WORK FORCE ROSE 315% COMPARED WITH 2% FOR THE FORTUNE 500.

OUR COMPANY RANKED #97 IN THE DECEMBER 1982 SURVEY OF INC MAGAZINES LIST OF THE 500 FASTEST GROWING PRIVATELY OWNED BUSINESSES AND OUR WORK FORCE INCREASED 7 IN 1977 TO 130 TODAY.

OUR COMPANY BELONGS TO THE SMALL BUSINESS ASSOCIATION OF NEW ENGLAND MORE COMMONLY KNOWN AS SBANE.

ON MAY 3 & 4, 1983, OUR ORGANIZATION PRESENTED SOME ISSUES AT AN ANNUAL MEETING CALLED THE SMALL BUSINESS UNITED WASHINGTON PRESENTATION. ONE OF THESE ISSUES WAS THE SMALL BUSINESS PARTICIPATION DEBENTURE.

AMERICA BECAME GREAT BECAUSE OF THE FORESIGHT AND COURAGE OF TWO VERY DIFFERENT SEGMENTS OF OUR ECONOMY. ONE WAS PRESENTED BY THE HARD-WORKING, INNOVATIVE ENTREPRENEUR AND THE OTHER BY HIS PARTNER, THE WEALTHY INDIVIDUAL OR FINANCIAL INSTITUTION THAT SUPPLIED FUNDS FOR NEW AND EXPANDING ENTERPRISES TODAY, WE HAVE PLENTY OF SMALL BUSINESS OWNERS WHO CAN FILL THE FIRST ROLE AS WELL AS EVER, BUT, UNFORTUNATELY, THERE ARE FEW FINANCIAL RISK-TAKERS WILLING TO SUPPORT THEIR VENTURES.

1) THE MOST COMMON SOURCE OF FUNDS IN THE PAST HAS BEEN COMMERCIAL BANKS; BUT WITH THE GRADUAL DISAPPEARANCE OF THE SMALL, LOCALLY OWNED AND MANAGED BANK, THESE FUNDS HAVE BECOME LESS AVAILABLE. LARGE, STRUCTURED BANKS ARE FAR LESS LIKELY TO FINANCE CLOSELY-HELD COMPANIES THAN WERE THEIR OWNER-MANAGED PREDECESSORS.

2) MORE AND MORE OF THE NATION'S WEALTH IS BEING ACCUMULATED BY INSURANCE COMPANIES; PENSION BENEFIT TRUST AND OTHER INSTITUTIONS. REGULATIONS AND TRADITIONAL INVESTMENT HABITS PREVENT THESE FUNDS FROM BEING DIRECTED TOWARD RISK SITUTATIONS. IN FACT, EVEN LOW RISK SITUATIONS, IF THEY INVOLVE SMALL BUSINESSES, HAVE A LACK OF ACCEPTANCE IN THE INSTITUTIONAL MARKET PLACE.

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3) THE MOTIVATION FOR AN INDIVIDUAL INVESTOR TO DIRECT HIS FUNDS TOWARDS SMALL BUSINESS HAS VIRTUALLY DISAPPEARED. IF HE WANTS TO BECOME A "LENDER", HE WOULD HAVE TO CHARGE AN INCREDIBLY HIGH INTEREST RATE TO WARRANT THE ADDITIONAL RISK HE WOULD BE TAKING COMPARED TO MONEY MARKET FUNDS. WHATEVER INTEREST RATE HE EARNS, HOWEVER, WILL BE SUBJECT TO ORDINARY TAX RATES, AND IF THE INVESTMENT IS BAD, HE WILL INCUR A CAPITAL LOSS, HAVE RELATIVELY LITTLE TAX BENEFIT TO OFFSET THE ECONOMIC LOSS. ON THE OTHER HAND, SHOULD HE TURN TO A PURCHASE OF EQUITY, THERE IS NO WAY TO REALIZE EITHER RETURN OF OR RETURN ON THE INVESTMENT WITHOUT EITHER SELLING THE HOLDINGS OR BEING PENALIZED BY THE PROHIBITIVE DOUBLE TAX ON DIVIDENDS.

4) THERE ARE A LIMITED NUMBER OF PRIVATE VENTURE CAPITALISTS. THOSE THAT DO COMMIT CAPITAL TO EMERGING BUSINESSES TRADITIONALLY FINANCE ONLY RISK SITUATIONS WITH A POTENTIAL FOR EXTRAORDINARY GROWTH, NOT TRADITIONAL EXPANSION. IN MANY INSTANCES, A SUBSTANTIAL AMOUNT OF EQUITY AND CONTROL MUST BE GIVEN TO THE VENTURE CAPITALIST IN ORDER TO SECURE THIS FINANCING WE SMALL BUSINESSMAN OF TODAY FIND THESE CONDITIONS UNACCEPTABLE.

WE BELIEVE THAT THE SBPDs WILL FINALLY PROVIDE THE MUCH NEEDED, NEW SOURCE OF CAPITAL FOR SMALL BUSINESSES. IT APPEARS TO SOLVE MANY OF THE PROBLEMS ENUMERATED ABOVE.

AN SBPD OFFERS TO THE SMALL BUSINESS CAPITAL WITHOUT GIVING UP EQUITY OR HAVING TO TAP EXISTING SOURCES OF DEBT FINANCING WHICH, IF AVAILABLE, ARE OFTEN UNAFFORDABLE. FOR THE INVESTOR, AN SBPD OFFERS A STATED RATE OF RETURN, PLUS A NEGOTIATED SHARE OF THE PROFITS, FOR A LIMITED PERIOD OF TIME.

THE APPROACH SHOULD ATTRACT NEW INVESTORS BECAUSE IT WILL OFFER AN OPPORTUNITY TO SHARE IN THE FRUITS OF A POTENTIALLY FLOURISHING BUSINESS. POTENTIALLY UNLIMITED PROFITS AS OPPOSED TO A STATED INTEREST RATE, TAX TREATMENT OF SUCH INCOME AT THE CAPITAL GAINS RATE AND LIMITED DOWNSIDE POTENTIAL (A LOSS MINIMIZED BY A TAX WRITE-OFF).

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INVESTORS WOULD BE ANYONE WHO WANTS TO INVEST IN THE FURTURE OF AMERICA THROUGH SMALL BUSINESS, PROVIDED BY THE TAX ATTRIBUTES OF THE INVESTMENT ARE COMPATIBLE. FOR EXAMPLE, INDIVIDUALS WHO HAVE CONFIDENCE IN A PARTICULAR ENTREPRENEUR, WOULD NO LONGER BE RELUCTANT TO RISK THEIR CAPITAL IN THIS MANNER. BANKS AND INSURANCE COMPANIES WOULD BE MOTIVATED TO ALLOCATE SOME OF THEIR MONIES INTO THIS EXCITING SEGMENT OF THE ECONOMY. FINALLY, EVEN THE SMALLER INVESTOR COULD PARTICIPATE THBOUGH INVESTMENT PARTNERSHIPS WHICH WOULD POSSIBLY SPRING UP. THESE PARTNERSHIPS, PROBABLY SPONSORED BY INVESTMENT BANKERS, MIGHT SELL ITS UNITS FOR AS LOW AS $5,000. EACH PARTNERSHIP WOULD THEN MAKE MANY INVESTMENTS, THEREBY REDUCING INVESTOR RISK THROUGH DIVERSIFICATION. NATURALLY, THE TAX ATTRIBUTES OF THE INVESTMENTS WOULD PASS THROUGH TO THE INDIVIDUAL PARTNERS.

THE INVESTOR WILL FIND THAT NEW OR EXPANDING BUSINESSES WILL BECOME ONE OF THE BEST PLACES FOR HIS MONEY, RATHER THAN ONE OF THE WORST. HE WILL HAVE THE BENEFIT OF REALIZING THE APPRECIATION OF HIS INVESTMENT AT CAPITAL GAINS RATES WITHOUT HAVING TO DISPODE OF IT. THE POTENTIAL GAIN ON A SUCCESSFUL INVESTMENT WITH THE SECURITY AND YIELD POTENTIAL OF A NOTE, WITH THE UPSIDE POTENTIAL AND TAX ATTRIBUTES OF STOCK.

FOR THE ENTREPRENEUR, SBPDs WILL MAKE AVAILABLE DESPERATELY NEEDED FUNDS FOR PRODUCT DEVELOPMENT, MARKET DEVELOPMENT OR PHYSICAL EXPANSION. THE TYPICAL SMALL BUSINESSMAN WILL NOT MIND GENEROUSLY SHARING HIS PROFIT AS LONG AS HE KNOWS THAT HE IS IN CONTROL OF HIS COMPANY AND THAT THERE IS A PREDETERMINED METHOD FOR HIM TO PAY OFF HIS PARTNER WHEN HIS BUSINESS CAN OBTAIN CONVENTIONAL FINANCING.

AN ADDTIONAL ADVANTAGE IS THE PROBABILITY THAT THERE WOULD BE NO ACTUAL COST TO THE TREASURY. THE MORE LIKELY RESULT WOULD BE THAT SUCH AN INVESTMENT WOULD BEGIN A CYCLE OF ACTIVITY THAT WOULD GENERATE CAPITAL INVESTMENT, NEW JOBS AND MORE FEDERAL REVENUES.

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VARIOUS FORMS OF THE SBPD HAVE BEEN PROPOSED FROM TIME TO TIME IN BOTH HOUSE OF CONGRESS. SMALL BUSINESS UNITED IN ITS WASHINGTON PRESENTATION GIVE PROMINENT ATTENTION TO THE SBPD. GROWING SPONSORSHIP AND SUPPORT SEEM TO BE ADDING MOMENTUM TO THE SBPD MOVEMENT, BUT A MUCH GREATER ACCELERATION OF ACTIVITITES IS NEEDED.

THE SMALL BUSINESS PARTICIPATING DEBENTURE (SBPD) WOULD BE A HYBRID SECURITY ISSUED BY A QUALIFYING SMALL BUSINESS, WHICH:

- WOULD BE A GENERAL OBLIGATION OF THE COMPANY
- WOULD BEAR A STATED RATE OF INTEREST NOT LESS THAN A STANDARD IMPUTED INTEREST RATE SPECIFIED BY THE SECRETARY OF THE TREASURY
- WOULD HAVE A FIXED MATURITY DATE
- WOULD GRANT NO VOTING OR CONVERSION RIGHTS IN THE COMPANY
- WOULD PROVIDE FOR THE PAYMENT TO THE INVESTOR OF A SHARE OF THE COMPANY'S TOTAL EARNINGS
- WOULD PROVIDE AN ORDINARY DEDUCTION TO THE COMPANY OF BOTH THE INTEREST AND SHARE OF EARNINGS

THE SPECIFIED TERMS OF THE SBPD, SUCH AS THE INTEREST RATE, MATURITY DATE AND SHARE OF EARNINGS, WOULD BE NEGOTIATED AT ARMS LENGTH BETWEEN THE COMPANY AND THE INVESTOR WITH NO GOVERNMENT INVOLVEMENT.

THE STATED INTEREST RECEIVED WOULD BE TAXABLE TO THE INVESTOR AS ORDINARY INCOME, HOWEVER, AMOUNTS PAID AS A DISTRIBUTION OF THE SHARE OF THE COMPANY'S EARNINGS WOULD BE TAXABLE TO THE INVESTOR AT THE PREFERENTIAL LONG-TERM CAPITAL GAINS RATE. AN INDIVIDUAL INVESTOR WOULD GENERALLY TREAT LOSSES ON SBPDs AS ORDINARY LOSSES.

A SBPD COULD ONLY BE ISSUED BY A DOMESTIC TRADE OR BUSINESS, WHETHER OR NOT INCORPORATED, WHICH HAS NET EQUITY OF LESS THAM TEN MILLION DOLLARS. ONLY COMPANIES WHICH DO NOT HAVE SECURTIES OUTSTANDING WHICH ARE SUBJECT TO SEC

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REGULATION WOULD BE ELIGIBLE TO USE SBPDs. ADDITIONALLY, NO COMPANY MAY HAVE ISSUED AND OUTSTANDONG, AT ONE TIME, SBPDs WITH A FACE VALUE IN EXCESS OF ONE MILLION DOLLARS.

THE SMALL BUSINESS PARTICIPATING DEBENTURE (SBPD) WOULD BE A DEBENTURE WHERE THE LENDER WOULD RECEIVE A STATED RATE OF INTEREST AND A SHARE OF THE EARNINGS OF THE BUSINESS DURING THE PERIOD THAT THE DEBENTURE WAS OUTSTANDING. THE INVESTOR WOULD BE PERMITTED TO SHARE IN THE FORTUNES OF THE BUSINESS IN MUCH THE SAME WAY AS A TRADITIONAL STOCKHOLDER, BUT PARTICIPATION WOULD TERMINATE WHEN THE DEBENTURE IS PAID OFF RATHER THAN CONTINUING INDEFINITELY.

THIS IDEA SHOULD PROVIDE A SIGNIFICANT INCENTIVE TO BRING DEBT CAPITAL INTO SMALL BUSINESS ON TERMS WHICH ARE ATTRACTIVE TO AN INVESTOR AND ACCEPTABLE TO THE TYPICAL BORROWER. CAPITAL GAINS TREATMENT TO THE LENDER ON THE SHARE OF EARNINGS PAYMENTS AND A TAX CREDIT FOR INVESTING IN AN SBPD. THE SMALL BUSINESS WOULD BE ENTITLED TO VIEW BOTH THE INTEREST AND THE SHARE OF EARNINGS PAYOUTS AS A COST OF CAPITAL AND DEDUCT BOTH OF THEM AS ORDINARY INTEREST.

AFTER ALMOST 50 YEARS OF GENERATING PROGRAMS TO DEAL WITH EMPLOYEES WHO ARE LAID OFF, WE STILL IN THIS WONDERFUL COUNTRY OF OURS HAVE NOT SOLVED THE UNEMPLOYMENT CRISIS OF THE 1980's.

THE SUCCESS OF THESE PROGRAMS HAS BEEN SEVERELY LIMITED DUE TO THE FOLLOWING FACTORS:

1) LIMITATIONS ON THE USE OF THE JOBS TAX CREDIT.
2) A LACK OF AWARENESS ON THE PART OF MOST EMPLOYERS THAT CREDIT PROGRAMS EXIST.
3) THE IMPLEMENTATION OF THE JOBS TAX CREDIT INVOLVES COMPLEX TAX RULES.
4) THERE IS A LIMITED LIFE TO THESE PROGRAMS AND FINALLY - THE APPLICATION OF THE JOBS TAX CREDIT IS TOO NARROW A GROUP OF EMPLOYEES.

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THE TAX CREDIT PROGRAM IS A POWERFUL INCENTIVE FOR LABOR - INTENSIVE SMALL BUSINESSES TO CREATE NEW JOBS. IT SHOULD INCORPORATE THE FOLLOWING:

1) IT SHOULD BE USED AS AN INCENTIVE FOR SMALL BUSINESSES TO INVEST IN HUMAN ASSETS RATHER THAN CAPITAL ASSETS.

2) IT SHOULD ACT AS AN INCENTIVE FOR SMALL BUSINESS TO INCREASE THE NUMBER OF EMPLOYEES ON A LONG TERM BASIS RATHER THAN ON A PART-TIME OR REPLACEMENTS.

3) IT SHOULD SERVE AS AN INCENTIVE TO PROVIDE JOB TRAINING TO UNSKILLED OR SEMI-SKILLED PERSONS.

4) IT SHOULD BE EASY TO USE.

5) IT SHOULD BE EASY TO UNDERSTAND AND PUBLICIZE THROUGH MAILINGS TO OUR EMPLOYEES WHO PAY PAYROLL TAXES.

6) IT SHOULD NOT NEED A LONG CERTIFICATION PROGRAM.

7) IT SHOULD BE BASED UPON NEW HIRES RATHER THANTYPES OF EMPLOYEES HIRED.

8) IT SHOULD HAVE A PROVISION THAT EXCESS CREDITS BE HANDLED BY REFUNDS RATHER THAN DIFFICULT CARRY BACK - CARRY OVER PROVISIONS.

9) IT SHOULD BE ADMINISTERED BY IRS THROUGH REPORTING ON THE INCOME TAX RETURNS.

ANY JOBS CREDIT PROGRAM WOULD PROVIDE AN INCENTIVE FOR SMALL BUSINESS TO HIRE NEW EMPLOYEES AT A QUICKER PACE.

THIS WOULD RESULT IN REMOVING PEOPLE FROM THE UNEMPLOYMENT SECTION TO THE TAX PAYING SECTION RESULTING IN A POSITIVE RATHER THAN NEGATIVE INPACT ON THE U.S. TREASURY.

TODAYS TAX LAWS PROVIDE VERY GENEROUS INCENTIVES TO CORPORATIONS THAT INVEST HEAVILY IN CAPITAL ASSETS, BUT THESE SAME TAX LAWS HAVE VERY LITTLE INCENTIVE FOR CORPORATIONS TO INVEST IN HUMAN RESOURCES. THE TIME HAS COME TO BALANCE THIS APPROVAL.

TO CLOSE ON A PERSONAL NOTE. I NOTE THAT TODAY'S DATE IS JULY 13 - IT IS ALSO THE BIRTHDAY OF MY 22ND YEAR OLD SON WHO IS CURRENTLY SERVING IN THE U.S. NAVY. THANK YOU-

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STATEMENT BY

MICHEAL R. BATEMAN

PARTNER

BATEMAN AND PAGE

CERTIFIED PUBLIC ACCOUNTANTS

NASHVILLE, TENNESSEE

BEFORE THE SUBCOMMITTEE ON

URBAN AND RURAL ECONOMIC DEVELOPMENT

SENATE SMALL BUSINESS COMMITTEE

JULY 13, 1983

Chairman Weicker and members of the Senate Subcommittee on Urban and Rural Economic Development, my name is Micheal Bateman and I am a partner in the firm of Bateman and Page Certified Public Accountants located in Nashville, Tennessee.

I am honored that you have invited me to testify before this subcommittee on the subject of capital formation for small business.

My firm is a small business and our client base is made up antirely of small businesses. As a result, I am keenly aware of the problems that small businesses face not only with capital formation but also with every other related problem including business-related family problems.

I wish to address specifically the use of tax law as a method of enhancing small business capital formation and retention. Since I am the tax partner of the firm, this is an area I feel qualified to speak on.

The first thoughts I had about all of this was why should the Federal Government even be involved in the area of small business capital formation? The answer to me was very simple. The Government is a partner in my business and in every small business. So why shouldn't it be involved in capital formation? As a matter of fact,

government is a very active and demanding partner. It has a significant say in the reporting method and period to be used. It requires that specific financial and non-financial data be furnished on a timely basis. It is very quick to respond when this information is not furnished on time or in a form other than that in which it was wanted. If you want to change any of these things in many cases this partner's permission must be asked first. And, of course, as with all partners it wants to share in the profit of the company. If this partner were a person the others involved would quickly ask him to put up or shut up.

However, the government would not and should not be a direct partner in small business. Government can and has helped in capital formation and retention in many ways including those proposals in Senate bills 371, 842, and 1043. Probably one of the best examples of tax legislation to encourage small business was the passage of the Investment Tax Credit. In my own practice, I've seen many decisions to buy new equipment made when the client realized that by the rapid write-off through ACRS deductions and the 10% tax credit that an immediate tax savings will reduce the financial strain caused by the assets purchase. This was an indirect way that the government has helped my clients retain capital.

One of the biggest problems my clients have is inadequate capital. They view the Government's current taxing position as an infringement on their existing and future capital formation. A significant factor in practically every major discussion is what will the tax consequences be? The sad thing is that tax law has evolved into such a complex body that sometimes it is hard to tell what the tax consequences might be. However, you have the ability to make these changes in tax laws to enhance capital formation.

The one largest expense for my clients generally is employees. Senator Sasser has introduced legislation to encourage businesses to hire the unemployed. I like this bill because several of my clients have expressed a desire to hire more people but feel that at this time the cost would be too much. Government can take an opportunity to invest in these clients' businesses through the wage credit allowed in this bill. The amendments he proposes will allow employers to draw on a larger pool of workers than is currently available with the Targeted Job Tax Credit. I looked through some old tax files back to 1977 when the General Job Tax Credit was available. I discovered that in that year approximately 25 new jobs were created because clients were able to take advantage of the credit available. Considering the size of my practice, I can say that this is a very significant increase in new jobs and taxable wages.

In Senate Bill 1043 it is proposed that the corporate tax rate be reduced again. I would like to see this tax reduction taken one step further to include reduced rates on the earnings of proprietorships and partnerships. These earnings can be separated, have a reduced tax rate applied then apply regular tax rates to other earnings of these people. Many of my small business clients operate as proprietors or partnerships because to operate as a corporation can be too costly and burdensome. I know of cases where corporations had little federal income taxes but rather large state Franchise and Excise taxes. Where if they were not incorporated, they would have had no state corporate taxes at all. Not every business needs to be incorporated. Remember, proprietors and partners must obtain capital too.

The small business participating debenture is an idea I find especially interesting. Recently a client was wanting to obtain long-term financing for business expansion. Several people approached him offering to invest in his business in return for an ownership position. He turned them down. Why? Because he was proud of what he had done with his business and wanted to retain complete ownership. Why did the people want to invest? Because the earning potential was there. The Participating Debenture as laid out in Senate Bill 842 could have been a very workable solution. My client would

have retained control and investors could have shared in the earnings of the company. Because of the favorable capital gains tax treatment of the earnings participation, the investor could receive small distributions while netting an after tax return equal to or greater than he might have received by receiving a larger dividend or interest payment. The company benefits by being able to make smaller earning distributions while increasing capital formation.

As you can tell I am in favor of any proposal to encourage or help small business. Congress has used tax laws in the past to induce social and economic change in our country. If our economy is to have any long-term or sustained growth, Government must help. You can start now with passage of those bills to help enlarge the capital base. Be a good partner with us, encourage us, help us with legislation. We will return your investment through increased jobs, increased efficiency and increased earnings and ultimately a greater tax base. You cannot lose.

Thank you.

Senator D'AMATO. Our third panel, Mr. Daniel Gregory, president of the National Venture Capital Association, and Mr. Edward Pendergast, Financial Planning and Consulting Corporation, Boston.

STATEMENT OF DANIEL S. GREGORY, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION, ACCOMPANIED BY EDWARD H. PENDERGAST, FINANCIAL PLANNING AND CONSULTING CORP.

Mr. GREGORY. Thank you, Mr. Chairman.

My name is Dan Gregory, and I am chairman of Greylock Management in Boston and general partner of the Venture Capital Partnerships that are part of that organization.

I helped start the company in 1965 and have been spending virtually all my time in venture capital since that time. I am currently president of the National Venture Capital Association, and I am before you today in terms of that membership of 144 firms not unlike my own. We think the NVCA membership is pretty much 50 percent or more of the venture capital professionals deployed today in the business.

I want to, at the outset, congratulate you, Mr. Chairman, and Senator Weicker and your committees and staff for paying such close attention to the SEC forum. I participated as a member of the executive committee and as a general member of the assembly, and can tell you at the outset it was an exciting thing for me. The SEC—although it was mandated, of course—had a most affirmative attitude. Chairman Shad, Commissioner Evans and members of the staff were very exciting to work with; they were listening. And I felt—quite in contrast to the mid-1970's, that small business was in fact getting its time and an ear. And that was a very, very positive thing and should be said.

I think the kinds of things that have happened in the last several years in a few selected areas of the country could very well become pervasive as this affirmative attitude takes hold. I am very pleased with that.

Let me describe just a little bit about my own firm in that it is reflective of the industry as a whole that I represent. My firm has a base capital in excess of $100 million. We are focusing exclusively on early stage and start-up ventures all across the country. We coinvest with other firms professionally organized like our own. Our own firm has been involved with the early days of about 160 companies. We have seen 67 of those go public and reach various levels of achievement that we are proud of, not the least of which—and the most important of which—is the new jobs created and the innovative products that have come out of that process.

We are usually involved with the companies in question—as most of my sister firms are—in the form of directorships or other evidences of close relationship with an emerging company.

I think it should be said that in the opinion of our members, the government's attitude toward capital such as we deploy and the taxation of that hopefully productive capital, is the foundation of most of the creativity of the vibrant elements of the entrepreneurial economy. The SEC report gave another good analysis of the his-

tory of the capital gains taxes and the impact on the allocation of risk capital to our kinds of companies as a result of that tax policy. And it certainly underscored the discouraging aspect which the 1969 and 1976 Revenue Reform Acts imparted toward the—in implementing a bias in the tax system against savings, investment, and risk taking. It was very, very clear.

We have supplied, with my testimony, some further figures that can be reviewed at one's leisure.

I think I like to look at it—being from Ohio originally—it is a seed corn thing. We were taxing our seed corn in this country. But now I think in terms of the new companies that are emerging we are seeing some of the new crops that have come up from the investment of funds that would have been taxed away, that might otherwise have been taxed away. And we are seeing some crops that come from the investment of funds which might not have chosen the very high-risk route and deferral of use for several years—it is a very long-term business—that comes from developmental investing, were it not for the differential that now exists between the income tax and capital gains.

It has got to be recalled that coincident with the 1969–1978 period and the high tax on capital gains was the stated objective of elimination of the difference between taxes on income and capital gains. In addition to the absolute rates of capital gains, long-term developmental investing such as ours is sensitive to the differential between tax on income and tax on capital gains. It is disappointing to note even the occasional reappearance of the simplistic notion that capital gains taxes and income just might be taxed at the same rate again.

I will go further than that. It touches the very nerve endings of the process; there is no mistake about it. The kinds of things that we are in—I am going to give you an example at the end—we would be out on a limb in a major way if there was a regression to that sort of thinking.

I am not just thinking about——

Senator D'AMATO. What would be your thought, Mr. Gregory, with respect to reducing the holding period of capital gains? What would that do, in your opinion?

Mr. GREGORY. First of all, our direct investment in the venture capital industry is very long term, and I would put that at 5 to 10 years. And yet, our projects need a liquid market. As Arthur Levitt indicated, we have to look to a public market for liquidity, for a means to raise further funds——

Senator D'AMATO. Do you see a turnaround of people, maybe when the stock market does, coming into some of your longer term things, a rush of capital? Wouldn't there be a tremendous capital infusion if you had a situation where you cut down the holding period?

Mr. GREGORY. No—well, I think we would have a much more viable—it has been very strong currently, but we would have a better outlook toward the viability of a public market to which we can issue companies.

Senator D'AMATO. What do you say, Mr. Pendergast? I see you shaking your head no. Do you disagree?

Mr. PENDERGAST. Well, I think small business' need for capital is long term; it is not short term.

Senator D'AMATO. I understand. But wouldn't that free up a lot of capital?

Mr. PENDERGAST. No, I don't think it would, because I think the difference between 6 months and a year isn't going to make the difference. I think it will create more churning within the market exchange-listed stocks. But that represents a very small percentage of business as far as numbers of units are concerned, and zero percent of small business.

Senator D'AMATO. OK.

Mr. GREGORY. I wanted to apply the same points about capital gains to the entrepreneur who frequently comes into the picture with no capital. And yet we, and others, who are supplying the funds carry those entrepreneurs and enable them to generate the equity values by the amount we are willing to work out with them as their equity state. And their view of the capital opportunity for them is very much impacted by the capital gains rates, obviously. People didn't leave in the early 1970's, IBM or Hewlett Packard, to start a new entrepreneurial situation. They instead chose the more conservative route.

They see things differently now because of the lower capital gains. And we are very sensitive to that preservation and very thankful for those who undertook the task in 1978 to reverse it.

We might generally feel that zero capital gains could prove their worth in time across the board, but we think it is more fitting to try to evaluate a further reduction of capital gains on selected bases such as you have under your consideration. We certainly would be very supported of 1043, which defines small business and provides for a further reduction on long-term capital gains for small business investments. Most of our companies when we start are small.

I think there is another thing that goes on in our process that should be considered in terms of selected further reduction, and that is that in this country we need to make some sort of a statement about the role and need and premium on long, long-term investing. We are at 6 months, 12 months, and beyond, and I think there should be further recognition of the long-term commitment. You give up your capital, there is no liquidity, there is no way out. Only to the extent that you can develop value in those companies whereby markets then can come by.

I don't want to sound in any way as though—back to your point—that we are not sensitive to liquidity factors for the public markets. We want to work with our colleagues who are responsible for security public markets, and we are sensitive to their problems. So that is where the shorter term rate becomes very important, and we have viable markets.

In the interest of time, and I know we are short of time, I just simply want to say that the other things on the minds of the—well, let me get to that in a minute.

On your observation with regard to corporate earnings, I again think—as was said earlier this morning—that retained earnings are a very, very important element in small business development. It enables an entrepreneur not to have to raise money from us

quite as soon or from others quite as soon. It is a form of self-financing to the extent the Government is willing to let a small business work with those retained earnings and retain them for a bit longer. Certainly those brackets are way out of line and ought to be realined. I applaud your attention to that very important problem.

One of the thoughts that we have had in the venture industry is that should there not be some moratorium on taxes during the first few years of an emerging situation? It is no coincidence that the first hit against earnings comes from the Government, and it is before dividends are paid, it is before salaries are other than minimal. It also coincides with the initial public offerings of stocks, frequently. You get not only the first profitable year where you have got some big taxes, but you have got to pay in anticipation of your coming year.

Other things on our mind: ERISA, we are encouraged that the Department of Labor recognizes the plan asset problem and pleased that that is getting some attention. ISO's, we are doing—incentive stock options—we are doing some studies via Arthur Young and will have some material available for everybody's review as to how that might be a more useful—might be made to be a more useful device.

Before closing and turning it over to my colleague here, let me make just a couple of comments about the venture capital industry as it stands today.

I think in our area we have had a very vibrant climate. We are asked to comment to different countries around the world about what this process is of entrepreneurial high-tech investing. We try to tell it. We've had an awful lot of capital come in; I don't think it is a question of too much capital chasing too few opportunities. I think that over and over again we have proven that the imagination and creativity of entrepreneurs way exceeds the capital available. These projects are backed by technological developments that are substantial in a sort of once-in-a-lifetime period of technological advance.

According to the conclusion of the Senate Finance Committee hearings held in January, there is a shortfall of venture capital in the neighborhood of $7 billion, which is about the number presently devoted to venture capital. It wouldn't suprise us if that proves to be an understatement.

We have put into place a lot of companies in this country who are very expensive to fund up front that are very reliant upon further venture capital financings, very reliant on the public market that we need to pay attention to in terms of liquidity. There are a lot of companies that wouldn't have been born 15 years ago that are capital intensive.

I came from a meeting yesterday of a company that I think is worth just capsulizing the history. It was formed in June 1981. They built their first product, a computer, a 68,000 unit base system, by June 1982. Their first shipment was November 1982. They have 125 employees at this point in time. They have just finished shipments in June 1983 of $2.2 million. They have orders for $5 million. We have GSA approval and product of the year from Electronics Products Magazine. But it took $17 million of venture

capital to get this far. And we are still losing money. We will lose money through June 1984 of $2.9 million. Now, we have got to fund that. We have got to fund it with our own funds, with new venture capital investors or the public market. We would like to be able to go public, and we think we have got—incidentally, very important——

Senator D'AMATO. Then 842 in that case might prove to be particularly useful, would you not say, sir? That bill that Senator Weicker has put forth? Wouldn't that enhance your venture capital?

Mr. GREGORY. Yes; it would give us a tool; it would give us an important tool. No question about it, a very important tool.

We held our meeting, you should know, in a 60,000-square-foot shell of a plant that is under construction, built with IRB's. They were very important in the process.

Senator D'AMATO. Send a note to Speaker O'Neill.

Mr. GREGORY. I will.

But there is a capsule, there is an example of a company. We funded it up front. We have compressed the normal long period of time that it would have taken to introduce products like that. We feel it is justifiable as a compression in time because the technology is moving so fast we have to be out there with our salesmen. We have got 11 sales offices around the United States already. We have just got to capture this point in time. So it is venture capital, up-front funded, very sensitive to capital gains rates; very sensitive. That whole process, and not only the 125 people who are now there, but the 389 we will have by year end of 1984. That will go away if we regress on what is now working as a capital gains principle.

I think it is right on the mark to encourage and to do what you are doing, to come up with ways for further edging that capital gains tax down to focus on areas, small business, or developmental investing—that is to say, primary investing for the long pull. I think it is worthwhile to really debate those issues. And I certainly applaud your version of that selective approach to further reduction.

I guess I would just say in the end, we are, as an industry, expanding rapidly. I hope it is not an early basis. Ten years ago no one would have imagined that there would have been today's number of startups and expanding, innovative enterprises. But, you know, it has happened and it is going to continue to happen. I think we are going into the 1980's and 1990's with a much more broad-based entrepreneurial investing activity. And I think it has grown out of recognition on the part of the Government of the problem that we did have earlier.

I want to thank you very much for letting me just say a few words. I hope I haven't impinged on your time.

Senator D'AMATO. That's quite all right. And I enjoyed your presentation, Mr. Gregory, because I think you have touched on something, that sometimes we get so down on what we have seen taking place and what we are maybe even still living through, with the old industrial base and the old plants, and we hear it over and over, and we are going to have to modernize and become competitive. And the fact of the matter is that you and many others in

your area are doing exactly that. And it is broad-based technical recovery taking place, and more than technical recovery and in more than just high-tech areas. And they are out there and they are doing this in increasing numbers. And never before, I think, has this Nation seen a situation where so many trained, talented groups are coming together. I think we are just going to see this continue to grow. And I am not just talking about the computer area. I am talking about all of the very dynamic areas of business/industrial growth.

It is there, and it is ahead, and we here have an opportunity to maybe give you a fighting chance and loosen up some of the shackles of—I don't want to get into the rhetoric of regulation, but the taxation regulation has to be looked at.

Mr. Pendergast.

Mr. PENDERGAST. Mr. Chairman, thank you.

In the interest of brevity, I would like my testimony entered into the record.

Senator D'AMATO. It shall be ordered to be placed in the record along with our distinguished chairman who did not get here. His opening statement will be placed in the record.

[The prepared statements of Senator Weicker, Mr. Gregory, and Mr. Pendergast follow:]

OPENING STATEMENT OF SENATOR LOWELL WEICKER, JR.
JULY 13, 1983, HEARING ON CAPITAL FORMATION

GOOD MORNING. I'D LIKE TO START OFF THESE PROCEEDINGS BY COMMENDING MY GOOD FRIEND, SENATOR D'AMATO, FOR HIS CONTINUING EFFORTS ON BEHALF OF SMALL BUSINESS CAPITAL FORMATION. MY COLLEAGUE FROM NEW YORK HAS BEEN UNDAUNTING IN HIS ATTEMPTS TO IMPROVE THE FINANCIAL CLIMATE FOR SMALL FIRMS, WHETHER IT BE THROUGH INDUSTRIAL DEVELOPMENT BONDS OR NEW TAX INCENTIVES, AND I HOPE THE SMALL BUSINESS COMMUNITY REALIZES WHAT A VALUABLE ALLY AND ADVOCATE THEY HAVE HERE.

A LARGE PART OF THE ADVOCACY ROLE WHICH I BELIEVE THIS COMMITTEE SHOULD PLAY IS THAT OF KEEPING THE ISSUES AND CONCERNS OF SMALL BUSINESS PEOPLE BEFORE THE CONGRESS AND THE POLICY-MAKERS OF THIS COUNTRY. THE PROPOSALS THE SUBCOMMITTEE WILL BE REVIEWING TODAY ARE PART OF THAT ONGOING PROCESS. MANY OF THEM ARE NOT NEW; IN FACT, IT HAS BEEN FOUR YEARS SINCE WE INTRODUCED THE FIRST VERSION OF S. 842, AND MADE THE FIRST TRY TO GET THE SMALL BUSINESS PARTICIPATING DEBENTURE ENACTED INTO LAW. THIS TIME, ON

BEST COPY AVAILABLE

ITS THIRD GO-ROUND IN THE SENATE, I AM HOPEFUL IT WILL BE ENACTED. I AM SURE SENATOR D'AMATO IS EQUALLY OPTIMISTIC ABOUT THE PROVISIONS OF HIS BILL, S. 1043, OF WHICH I AM PROUD TO BE A COSPONSOR. AND I KNOW SENATOR SASSER WOULD LIKE TO SEE S. 371 BECOME LAW AS WELL.

WHILE THE TIMING MAY NOT BE RIGHT FOR PASSAGE OF ALL OF THESE MEASURES, I AM GLAD TO SEE THAT THEY ARE BEING DISCUSSED AS PART OF THE NATIONAL DEBATE OVER HOW BEST TO ATTACK THE PROBLEMS OF GROWING UNEMPLOYMENT AND DECLINING PRODUCTIVITY.

A MAN WHO KNOWS THE INS AND OUTS OF OUR POLITICAL PROCESS AS WELL AS ANYONE IS ARTHUR LEVITT, WHO, AS CHAIRMAN OF THE 1980 WHITE HOUSE CONFERENCE ON SMALL BUSINESS AND THE CHAIRMAN OF THE AMERICAN BUSINESS CONFERENCE, HAS BEEN FIGHTING FOR SMALL BUSINESS AS LONG AS ANY OF US HERE TODAY. ARTHUR IS A POWERFUL AND KNOWLEDGEABLE FORCE, AND I AM ALWAYS GLAD TO HEAR WHAT HE HAS TO SAY. ARTHUR, IT IS GOOD TO SEE YOU HERE TODAY.

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TESTIMONY OF

DANIEL S. GREGORY

PRESIDENT

GREYLOCK MANAGEMENT CORPORATION

BOSTON, MASSACHUSETTS

AND

PRESIDENT

NATIONAL VENTURE CAPITAL ASSOCIATION

BEFORE THE

U.S. SENATE

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON URBAN AND RURAL DEVELOPMENT

JULY 13, 1983

TESTIMONY BEFORE THE

UNITED STATES SENATE

SENATE SMALL BUSINESS COMMITTEE

SUBCOMMITTEE ON URBAN & RURAL ECONOMIC DEVELOPMENT

Presented July 13, 1983

Mr. Chairman:

My name is Dan Gregory, Chairman of Greylock Management Corporation and General Partner of the venture capital limited partnerships which comprise the total Greylock organization. Greylock commenced operations in 1965 and I have devoted substantially all of my professional business time to Greylock since that time.

I currently serve as President of the National Venture Capital Association and I am before you today on behalf of that 144 member organization. We estimate that the NVCA membership comprise a majority of the assets professionally managed in the venture capital industry.

The Greylock organization has a combined base capital in excess of $100 million. This capital has been and continues to be deployed in a number of new small businesses, most of which have grown and prospered, creating new jobs and innovative new products and services. We have played a financial role with approximately

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160 enterprises, and because of their levels of success, along with the new streams of corporate earnings thereby generated, substantial new capital has been formed together with new equity values.

Most of our investments have been early stage or startup financing. Almost all of these projects require a very close working relationship with management and as evidence of that, we participate on the Boards of two thirds of our companies.

You, Mr. Chairman, and Senator Weicker, your committee, and your staffs are to be commended for your study of last fall's SEC sponsored Government-Business Forum and for your determination to act upon certain of the recommendations made by the Forum. I served as a member of the Forum's Executive Committee and as a general participant at the Forum itself. I can report to you at the outset that the affirmative attitude displayed by Chairman Shad, Commissioner Evans, and the involved members of the SEC staff was itself a very positive thing. Gentlemen, with the spirit that prevailed at that Forum, with your willingness to work with some of the ideas that were forthcoming, and those of us on the firing line doing our jobs, the bright era of entrepreneurial activity bringing products of new technologies to the marketplace will play a strong role in the recovery of our economy. What we have seen in a few selected areas in this country will become pervasive, contributing to the greater benefits of the country as a whole.

In the opinion of our membership, the government's

attitude toward capital and the taxation of productive capital, is the foundation for most of the creativity in the vibrant, innovative elements of the economy. The SEC Final Report on the Forum provided another good analysis to support the proposition that increases in the capital gains tax implemented by the tax reform acts of 1969 and 1976 discouraged productive investment by implementing a bias in the tax system against savings, investment and risk-taking. New capital committed to venture funds plunged to $39 million for the year 1977. Since the reversal of these policies in 1978, there has been a steady influx of risk funds. In 1982 alone, $1.7 billion additional funds were committed to professional venture capital organizations for deployment in innovative venture situations. The usefulness of public markets to small companies is also dramatically influenced by tax policy. First time common stock offering by fledgling business dropped from 1200 in 1968 to 58 in 1978. Figures through 1981 show a strong resurgence. Addendum A conveys further relevant figures on the subject of taxes on capital gains.

For a period, we were taxing our seed corn in this country. Now, however, we are seeing new crops that have developed from the investment of funds which might have otherwise been taxed away. Similarly, we are seeing new crops from the investment of funds which might not have chosen the high risk route of long term developmental investing, were it not for an attractive differential between income tax rates and rates on

capital gains. It must be recalled that coincident with 1969-78 high tax on capital gains was the stated objective of eliminating the difference between taxes on income and capital gains. In addition to absolute rates of capital gains taxes, long term development investment is sensitive to the differential between rates of tax on income and capital gains. It is disappointing to note even the occasional reappearance of the simplistic notion capital gains and income should be taxed at the same rate.

The above comments relate to the impact of capital gains taxes on existing capital and how it is channelled. Equally important is how capital gains taxes impact the incentives of an entrepreneur to give up the security of an established job with its high income and choose the highly productive, high risk road of new company formation and technological development. We believe one of the most important single elements of a strong entrepreneurial environment is the existence of the opportunity for individuals to generate and keep capital. It is a uniquely American phenomenon whereby an entrepreneur can convert his technical expertise and his leadership into longterm capital values and to retain a substantial amount of these values generated, reflective of his contribution to the economy and society.

So we are thankful for the wisdom and courage of those who restored lower capital gains taxes, and restored the differential of capital gains taxes from the rate of taxes on income. We feel the recent dynamism of new company formation and

technological development speak to the appropriateness of their efforts. While we might genuinely feel that zero capital gains taxes would prove their worth in time also, we feel it more fitting to evaluate the further reduction in capital gains taxes on a selected basis. We are heartened by your interest in this concept as embodied by your Senate Bill 1043, which would provide further incentive to make longterm investments in small businesses, as defined. A variation of this worthy of consideration is an increased exclusion on investments which were original issue or primary investments and held for the long term (three to five years). While helpful to developing companies, such as those frequently backed by the venture capital industry, the benefits of such an approach would extend well beyond the parameters of simply the venture capital industry.

Nothing herein is meant to impair the liquidity or the viability of public markets for companies backed with developmental funds. We share with those engaged in maintaining those public markets, the desirability of minimal holding periods wherever possible. We understand the need of emerging companies to look to a viable public market, which we believe to be facilitated by minimal capital gains rates and shorter term holding periods. We are suggesting instead the further reduction of capital gains, but on a selected, longterm holding.

Moving on, we totally endorse the rollover provision of Bill 1043, and we fully endorse the establishment of a 20% maximum corporate capital gains rate.

We cannot add to your keen observations with regard to the role of corporate earnings, in financing the growth in otherwise capital starved small business. We would certainly concur with the need to realign corporate brackets and have also given some thought to some form of moratorium on taxes during the formation years of a new enterprise.

Turning to other issues of interest to the NVCA, The Department of Labor E.R.I.S.A. regulations are under review, as they impact the investment of pension funds in venture capital pools. There appears to be little debate that pension funds should be the source of some of the venture capital funds and we are encouraged that E.R.I.S.A. regulations can be developed to provide for this without those funds being deemed Plan Assets. There is a further regulatory matter that has to do with the proposed debt/equity, Section 385 regulations. Similarly, we are encouraged by the Treasury's recent view suggesting that the fourth proposed draft of such regulations may be withdrawn as unworkable, particularly for small company financings.

Finally, we would mention another concern, restrictions preventing Incentive Stock Options (ISO's) from being a particularly useful tool in attracting key people to our emerging companies. There is currently a $100,000 limit on ISO's and in addition, the ISO's are currently a tax preference item. Enclosed is an addendum describing the ISO issue for your possible review.

Before closing, let me make a few comments about the venture capital industry as it stands today. We are experiencing a vibrant entrepreneurial climate which most of the democratic world is trying to emulate. It is sometimes said that too much capital is chasing too few deals, and that we are supporting businesses that are otherwise unsustainable. It is our earnest belief that the imagination and the creativity of today's entrepreneur will continue to outrun the availability of capital. According to the conclusions of the Senate Finance Committee hearings held in January of this year, there is a shortfall of venture capital in the neighborhood of $7 billion, which is approximately the size of the present-day industry. It would not surprise us if this proves to be an understatement. We continue to be confident of the venture capital industry's ability to expand on an orderly basis. Ten years ago, no one would have imagined that there would be today's number of startups, and expanding innovative enterprises which could absorb the substantial new funds available today. Most people would not have projected that the demand would keep up to the $7-8 billion supply of venture capital.

Given continued support by governmental policies, and with continued self-discipline on the part of the venture capital industry, we expect to do our share in spawning an increasing number of innovative and contributing companies to our economy in the future.

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ADDENDUM A

EXECUTIVE SUMMARY

The data obtained from the venture capital industry by Venture Economics, a subsidiary of the Capital Publishing Corporation, clearly shows a direct correlation between the reduction of the rate of tax on capital gains and the growing availability of funds to the venture capital industry for investment in new emerging companies.

The capital gains rate reduction of 1978 and 1981 and the subsequent increase in the differential between the tax on capital gains and the tax on personal service income dramatically encouraged investment funds for the development of new small businesses.

The National Venture Capital Association recommends that since the August 1982 General Accounting Office Study shows that venture investment has an extremely positive impact on the economy that additional capital gains reforms be instituted as follows:

a) reduce the maximum corporate capital gains rate to 20 percent;

b) increase the exclusion to 80 percent for gains realized on original issue securities held for at least five years, and

c) authorize a deferred payment of capital gains taxes if the proceeds of a liquidated capital asset are "rolled over" into a small business concern.

CAPITAL GAINS TAX

Beginning in 1969, Congress gradually increased the long-term capital gains tax rate so that by 1977 the maximum rate stood at just over 49 percent. In 1978, that trend was reversed as the rate was reduced to 28 percent. A further reduction to 20 percent was enacted in 1981. During the three years preceding the initial 1978 reduction, venture capital firms only invested $1.8 billion in new business ventures. In the three years following 1977, $5.4 billion was invested by the venture industry in the innovative, independent business sector which represents a 300 percent increase over the earlier period. This increased investment activity was all made possible by a corresponding infusion of new capital into professionally managed venture capital firms.

The following table shows the yearly funding and disbursement levels.

VENTURE CAPITAL INDUSTRY

ESTIMATED
FUNDINGS AND DISBURSEMENTS
(Millions of Dollars)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Public Underwritings of Companies with a Net Worth of $5 Million or Less	
			Number	Amount
1982 Est.	$1,700-$1,800	Up somewhat	(112)	$ 617
1981	1,300	$1,400	(306)	1,760
1980	900	1,000	(135)	822
1979	319	1,000	(46)	183
1978	570	550	(21)	129

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Public Underwritings of Companies with a Net Worth of $5 Million or Less	
			Number	Amount
	Capital Gains Tax Decrease			
1977	39	400	(22)	75
1976	50	300	(29)	145
1975	10	250	(4)	16
1974	57	350	(9)	16
1973	62	425	(409)	896
1971	95	410	(248)	551
18=970	97	350	(198)	375
	Capital Gains Tax Increase			
1969	171	450	(698)	1,367

After the 1978 legislative action, there was a commensurate increase in initial public offerings which is an important ingredient in creating a favorable climate for venture investing. The chart below illustrates the total dollar volume for all companies going public for the first time regardless of net worth of the corporation.

NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS
(in Millions)

1975	1976	1977	1978
$265	$234	$153	$249
1979	1980	1981	1982
$506	$1397	$3215	$1445

It is thus obvious why both government and private sector analysts credit the two rate reductions with increased individual investment and risk-taking, stimulating entrepreneurial activity, accelerating the mobility of capital, and fostering new.productivity enhancing investment.

And best of all, these achievements were realized at no net cost to the Treasury. In fact, total capital gains tax revenue increased from $9.3 billion in 1978 to $11.2 billion in 1979, and $11.9 billion in 1980. The government realized additional "windfall profits" in 1982 as the "unlocking" or selling of seasoned mature investments continued to occur.

The benefit of a capital gains cut was recently underscored by the Chairman of the Council of Economic Advisers (CEA) when he stated the "amount of capital gains reported on tax returns increased dramatically in the years after the tax rate on capital gains was reduced. He went on to say the CEA analysis "shows that reported net long-term losses rose from $30.3 billion in 1977 to $63.8 billion in 1979, up 111 percent.

But, there is still a problem! Even after a three-fold increase in the amount of new capital being made available to young, growing small businesses, recent congressional hearings revealed that there is an estimated annual equity capital shortfall of between $6 and $7 billion.

To increase further risk taking and thereby divert more dollars to start-ups and young, high-growth, job producing concerns, three types of incentives should be enacted.

ONE: In 1981 and 1982 approximately 20 percent of all new capital committed to venture capital firms was corporate affiliated. That figure represents a sharp fall-off from the better than 30 percent contributed by corporations in the previous two year period between 1978 and 1980. One of the key reasons is that Economic Recovery Tax Act in 1981 failed to lower the maximum long-term corporate capital gain tax rate from 28 percent to 20 percent as it did for individuals. The simple solution to this disparity is to place the corporate investor on par with the individual taxpayer and make the maximum applicable rate 20 percent for both.

TWO: A distinction needs to be made between the commonly thought of long-term investment of between six and twelve months, and the very long-term financing that is held for five years or longer. Such a distinction is needed for it would more accurately reflect the long-term nature and recognize the higher level of risk associated with the typical venture investment. This illiquid, very long-term capital commitment should be rewarded by increasing the exclusion to 80 percent for those gains realized on the sale of securities purchased directly from the corporation, not in the secondary market. The net effect is that the maximum capital gain rate would be reduced to ten percent.

THREE: Still a further incentive should be considered. If the realized gains of a capital investment were reinvested in or "rolled over' into a small business concern within an 18 or 24 month period, the payment of the applicable capital gains taxes could be deferred until the taxpayer sold the small business

securities and did not "roll over" the proceeds into still another small company.

An August 1982 GAO study on the venture capital industry provides ample evidence of the benefits that would be multiplied if these capital gains related provisions were enacted. GAO studies 1,332 emerging businesses financed between 1969 and 1977, a period where U.S. tax policies are described by GAO as having "damaging ripple effects on business creation and risk taking." The study concludes:

> The experiences of 1332 companies that were started with venture backing during the 1970's demonstrate benefits to the nation's economy and productivity that are disproportionately large when compared with the amounts of capital invested. For example, with $209 million invested to create 72 of these firms, their combined sales in 1979 alone totalled $6 billion. Growth in annual sales averaged 33 percent a year and, in the process, these firms created an estimated 130,000 jobs, over $100 million in corporate tax revenues, $350 million in employee tax revenues, and $900 million in export sales.

If $209 million can produce this type of impressive and disproportionately beneficial results, imagine what would happen if between $10 and $20 billion a year were made available as a result of enactment of these three incentives.

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ADDENDUM B

EXECUTIVE SUMMARY

In 1975, Congress changed the tax treatment of qualified stock options which all but eliminated them as a significant incentive to attract management personnel to new emerging companies.

The tax law of 1981(ERTA) greatly improved the situation but did impose a $100,000.00 ceiling limitation for incentive stock options(ISOs). The tax law of 1982 further weakened the attractiveness of ISOs by saying that the "paper profit" or difference between the fair market value and the option price at the time of exercise will be included as a preference item when computing the alternative minimum taxable income of a taxpayer.

The National Venture Capital Association recommends eliminating the $100,000.00 ceiling limitation for incentive stock options for companies that are less than ten years old; and eliminating ISOs as a tax preference item.

INCENTIVE STOCK OPTIONS

Small companies have traditionally had difficulty attracting experienced, enterprising management personnel. Young businesses by definition do not offer the same kind of job security as do larger, established corporations. Further, growing concerns are traditionally cash starved, thereby making it difficult for them to offer competitive salaries.

For many years, the usual means of compensating for these deficiencies was to offer key employees a "piece of the action" in the company, usually in the form of stock options. If the company became a roaring success in the future, management personnel would be richly rewarded when they sold the stock they acquired through a qualified stock option plan.

Regrettably, in 1975 the Congress prohibited the further granting of qualified stock options. The utilization of options by venture capital portfolio companies immediately became unattractive as an executive was required to pay ordinary earned income tax on the difference between the option price and the market price at the date the option was exercised. Payment of taxes on this "paper profit" created an onerous burden as no cash was generated by the transaction from which to pay the tax. Further, the price of the security once acquired would sometimes decline precipitously. The taxpayer was thus sometimes left in the incongruous situation of paying ordinary income on a transaction that ultimately resulted in a realized loss to the taxpayer when he sold the securities.

On the other hand, the employer was entitled to a corresponding expense deduction equal to the amount included in the employee income which, when offset against the "gain" of the employee, invariably resulted in a net loss to Treasury.

This aggravating situation was rectified by the Economic Recovery Tax Act of 1981(ERTA) as it eliminated any tax consequence at the time an incentive stock option (ISO) was granted or exercised. Today, an employee is entitled to long term capital gains tax treatment when the securities are sold, provided the option:

(1) price equals or exceeds the fair market price at the date of grant;

(2) is granted under a plan approved by the stockholders;

(3) is granted within ten years of the date of the plan's approval;

(4) is exercisable only within ten years of the date of grant, and,

(5) is non-transferrable except upon death or disability of the holder.

Further, the employee is ineligible for such option if he directly or indirectly owns more than ten percent of the company's voting securities. This limitation is waived if the option price is at least 110 percent of the fair market value at the time of the grant and is not exercisable more than five years after the date of grant. In addition, the plan must place an annual limit on the amount of stock that can be granted to an employee, but in no event can the fair market value of the option stock exceed $100,000.00 plus any unused "carryover" amounts from prior years.

Operating under this artificially low ceiling causes a company to lose the flexibility needed to attract and retain skilled and experienced management talent. This is particularly the case when the option price per share has a high dollar value, for it takes a much greater number of securities to generate the same rate of return than would be required if the price per share was much lower.

This problem can and should be remedied by eliminating the annual $100,000.00 ceiling for companies of ten years of age or less. We understand that complete removal of the ceiling for all corporations regardless of age might cause an unacceptable revenue loss and would not necessarily create an economic benefit for the large, mature corporations whose stock is listed on a national exchange. However, limiting the removal to younger companies would serve to induce increased productivity and innovation.

One year after authorizing ISOs, Congress enacted the Tax Equity and Fiscal Responsibility Act (TEFRA) which seriously diminished the appeal of ISOs. Henceforth, the "paper profit", or difference between the fair market value and the option price at the time of exercise, will be included as a preference item when computing the alternative minimum taxable income of a taxpayer. Although not as pernicious as the pre-1981 non-qualified option problem where all "paper profits" were automatically subject to as much as a 50 percent tax, the potential liability of paying a 20 percent tax on ISO unrealized paper profits nevertheless makes ISOs much less attractive than originally intended in the 1981 legislation.

This second problem can easily be resolved by simply removing the punitive preference item classification.

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Statement by:

Edward H. Pendergast

President

Financial Management and Consulting Corporation

before

United States Senate Small Business Committee

Subcommittee on Urban and Rural Economic Development

Washington, D.C.

July 13, 1983

Mr. Chairman, thank you for this opportunity to address the issues of Small Business Capital Formation. My name is Edward H. Pendergast. I am a financial consultant to small business and my background includes many years as a small business activist as can be seen from my attached resume. I have served as a president of the Smaller Business Association of New England.

First I would like to commend the Senate Small Business Committee's Subcommittee on Urban and Rural Economic Development for holding these hearings and for the initiatives it has taken to facilitate small business access to capital. Your interest in following up on the SEC's Government-Business Forum recommendations is well worth the time you are committing to this effort.

It is not necessary to repeat what others have said about the importance of small business to our country. Suffice it to say that new job generations and successful exploitation of new technology have been unique characteristics of the small business. A quote relating to new business was helpful to me. "New businesses add products and services that improve choices for consumers and build competitive strengths for the nation against foreign rivals. Entrepreneurial ventures provide a competitive spur to existing companies, both large and small, stimulating them to improve quality and reduce prices to the benefit of buyers. They accelerate the advance and dissemination of new technologies which enhance national defense and the quality of life at the same time. The new jobs they create provide more alternatives for employment, particularly for many individuals who have difficulty finding or fitting into the rigid slots of established organizations. New ventures are territory essential for the pursuit of happiness by many. Through entrepreneurship more people become leaders and economic power becomes more decentralized, broadening the base for a democratic economy." (1)

As to the issues relating to capital formation, I will exclude discussion of those items that relate more to capital retention so to focus more on capital formation. Capital is defined for this purpose to include both debt and equity capital, since the difference is frequently clouded as evidenced by the IRS's inability to develop acceptable regulations under Internal Revenue Code Section 385 as to debt versus equity. Further, the sources of these funds are closely related.

The issues that I will focus on include three pieces of legislation, S.1043, S.371, and S.842 and some comments on interest rates, the competition for capital and an assortment of other issues. The emphasis here is not on giving favorite status to small business, but in reducing the disadvantages confronting small business.

(1) Karl H. Vesper, "Entrepreneurship and National Policy" Heller Institute for Small Business Policy Papers, 1983.

S.1043 The Small Business Capital Formation Tax Act

This legislation incorporates six of the recommendations of the SEC Forum previously mentioned. It is an excellent piece of legislation. Some parts deserve higher priority than others. Reduced corporate rates are always a number one priority, but I would have to examine the revenue impact of these changes. Sections 3, 4 and 5 relating to changes in the capital gains tax as it affects small business is the highest priority in S.1043 if the tax rate changes are viewed as too expensive. These are essential to re-channel the capital markets thinking into investment in the small company. The static revenue impact should be small and the dynamic revenue impact should be positive if the new job creation impact is included as a factor. Section 6 giving a 10% tax credit for an equity investment in a qualified small business is a good section but 5% might be more reasonable. Section 7 is the rollover section that is an excellent idea with little revenue impact because it should deflect the tendency of selling out to a public company. I would like to see the rollover to allow investment in a fund or institution that limits its investment to small business, thus allowing the investor to spread some of the risk. Section 5 relating to cash accounting for businesses with less than $1,500,000 in gross receipts is probably legislating what a significant percent of these small businesses are already doing. It is not so much a capital formation as a capital retention issue and might not belong in this bill.

S.371 Target Jobs Tax Credit Amendments Act of 1983

This is more appropriately a capital retention bill. Its cost is modest. If it results in otherwise unemployed people being hired, I suggest it will actually have a positive revenue impact. General jobs credits do not seem to inspire additional hiring. This bill may do this. If it does not, its revenue impact will be nothing as well. It will also give an incentive to the small labor intensive business that it needs. I support it.

S.842 Small Business Participating Debentures

This is the highest priority bill for me as it truly will generate new capital for small business. I think the $10,000,000 equity limit is too high. To start with, I would prefer $5,000,000. If a higher amount is deemed appropriate later it can be amended. I would like to see a lower minimum rate of interest since small companies have difficulty meeting interest payments when profits are low. My major additional concern is to inhibit banks from using the percentage of profits as an additional "kicker" to its regular loan rate for loans it would have made. A modest maximum interest rate would remedy this.

INTEREST RATES

Interest rates for small business are oppressively high when compared with those of our major competitors for these funds - large business and government. Small business is excluded from the open markets and is forced to go to banks or friends or sources of last resort. Government, particularly the federal government, with its huge deficits to finance, sop up a large percentage of available funds through bills and notes and other offerings at low rates. Big business through debenture offerings and commercial paper take another large chunk again at lower rates. When big business does come to borrow from banks it usually borrows well below prime rates as often evidenced by Federal Reserve figures. At August of 1982 for example the small borrower was paying 40% more for money than the large borrower! Historically this has tended to be closer to 20% which would still be a 2.5 point spread.(2) Even when the loan is 80% guaranteed by the SBA, small business usually pays 1.5% to 2% over prime rate. When the government guarantee portion is sold, it frequently is sold at a 4% per annum lower rate, allowing the bank to keep the difference. Thus a bank could easily have gross returns on its investment of 40% when prime is at 12%! At the same time an SBA Committee on Capital Access tries to make us believe that removing interest rate ceilings on SBA guaranteed loans would result in lower interest rates.(4) Caveat Emptor may be appropriate policy but no one ever felt the "emptor" got a better deal because of said policy.

What is needed is a comprehensive study to determine if small business loans justify a higher rate. Casual checks made by the author indicate that properly organized small business loan procedures are very profitable to a bank for at least five reasons. First, the loss ratio is reasonable. Second, the possibility for a major failure is reduced by a larger number of smaller loans. Third, small business

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(2) large borrower might pay 12%, small borrower 14.5%. The 2.5% difference is 20% of the 12% rate the large borrower will pay.

(3) Calculations are as follows for a $100,000 loan, 90% guaranteed when prime is 12% and loan is granted at 2% over prime or 14% and bank sells the guaranteed portion at a rate of 10%.

Bank's net investment is $10,000	
Income on $10,000 at 14%	$1,400
Income to bank on the $90,000 government portion 4% (Bank collects 14% and pays out 10%).	3,600
Income total	$4,000
Percentage yield to bank on its $10,000	40%

(4) The lone dissenter is the author of this testimony.

INTEREST RATES (Continued)

generates more demand deposits since it is not as sophisticated in money management techniques. Fourth, a good small business grows to become the major borrower in the future. Fifth, the small business tends to be more loyal to the bank that started out with it. The offset is obvious. Ten $100,000 loans require considerably more personnel expense than one $1,000,000 loan, but even that difference gets reduced if the bank has developed expertise in the industry. The traditional additional processing cost argument is still present but less significant with computers and by organizing a small business loan department so the processing becomes a routine. The question of small banks versus large banks and interstate banking are factors that should also be examined. The study should be the basis for legislation that will encourage banks to lend money to small business at competitive rates and in adequate quantities.

EQUITY CAPITAL

At the moment we are seeing large amounts of money chasing new high technology ventures that promise handsome profits in three to five years. One venture capitalist categorized "handsome profits" as any that approach the unconcsionable. Underwriters see the market as having an insatiable appetite for certain types of companies such as computers and biotechnology. Their salesmen are hungry for "product" (5) and issues are being offered as fast as they are available. Everyone talks about the "window of opportunity" and wonders how long it will be open. Hopefully, there will not be an overreaction similar to the late 60's that culminated in 1975 when there were only 4 public offerings of companies with a net worth of $5,000,000 or less.

The current quickening of the pulse obscures the real problems. First, only glamorous issues easily attract the needed capital whether in the public or private marketplace. Many good, solid business opportunities go begging because the earnings multiples are not outrageous enough. Second, with all the talk about venture money, private venture capital companies have about $7.6 billion in capital. Underwritings for companies with net worth or $5 million or less totalled about $620 million. This total of $8.2 billion is less than one mutual fund operation, Fidelity, has in its cash management fund, never mind its other funds. Further, as a percent of the total equity money available, small business receives a pitifully small amount, probably less than 10% for the 92% of businesses that have less than $5 million in assets even though these businesses generate 30% of gross receipts (6).

(5) Shares in a company going public.

(6) These are estimates from IRS data for corporations. Individuals proprietorships are not included. If they had been the figures would have been even smaller.

New initiatives are needed. I propose 4 in this brief testimony. There are many others we support and will be happy to discuss in detail now or at a future time. FIRST, I urge the creation of the Small Business Participating Debenture as discussed on page 2 under S371 which would be a hybrid security with a low fixed rate of interest plus a percent of profit to the debenture holder allowing capital gains to the holder for the percentage of profits and deductable by the small business of both the profits and interest. This would allow the informal investor an opportunity to reduce risk by being a debt holder while increasing the reward potential by participation in profits. SECOND, pension funds, insurance companies and other institutions should be encouraged to allot some portion of their funds for investment in small business. This can be done through ERISA "safe harbor" rules and even establishment of minimum goals. THIRD, the capital gains tax should be rewritten. The reduction of capital gains to a 28% maximum has been a major factor in releasing funds for investment. There is considerable room for improvement. Investments in small business generally tend to be less liquid and must be held for a longer period than those actively traded. To help offset this an initial investment in a small business should be given preferential capital gains treatment if held for 4 or 5 years. To help keep investments in small business, capital gains should be deferred in so-called "rollover" situations. These are situations where proceeds from the sale of a small business are reinvested in another small business or an investment company that specializes in small business investment. Most of these are covered in page 2 in discussion of S1043. FOURTH, the SEC should continue to modify its regulations to simplify the small business investment process and encourage state securities administrators to adopt a uniform exemption and regulatory process.

DISCRIMINATION

This is an issue that is hard to limit to capital formation because the discriminatory process pervades the laws and regulations at almost every pass. The result is frequently an indirect impediment to the small business and ultimately another inhibition of investment in the small business. The following are some examples. The so called "reorg" sections of the Internal Revenue Code encourages a small business to sell out to large business thus increasing concentrations of business. Accumulated earning tax is not applicable to large business. Fringe benefits such as medical insurance are allowed as deductible when for a $600,000 chief executive of a Fortune 500 company but not to the owner of a proprietorship, a partner in a partnership or a shareholder-employee in an S Corporation. If the small business has a Small Business Administration loan, it is not eligible for an Industrial Revenue Bond.

The remedy does not lie in a major lobbying effort on each bill affecting small business. Small business does not have the time or resources. The answer lies in small business representation in the legislature and regulatory process. If legislation mandated a small business appointment to the SEC, the Federal Reserve System, the IRS and other regulatory agencies and legislature bodies, there would be opportunity for adequate consideration of the impact of

DISCRIMINATION (Continued)

governmental actions on small business before the action became final. The result would be fair, well balanced legislation and regulation that would give fair consideration of the adverse impact of small size.

OTHER RECOMMENDATIONS

The comprehensive list of recommendations is attached as excerpts from Small Business United's 1983 Washington Presentation.

CONCLUSION

The health of small business is critical to the health of the American economy. As we change from an industrial to an information society, we need to foster the entrepreneurial spirit. The federal government's role should be that of a facilitator. Small business does not need preferential treatment, it needs fair and equitable treatment. Hearings like this should help greatly to achieve this end. The Senate Small Business Committee's Subcommittee on Urban and Rural Economic Development should be commended.

Attachment to Testimony of Edward H. Pendergast as Requested

Revenue Impact of the Small Business Participating Debenture

The estimated revenue gains or (loss) for each of the first 5 years is as follows ($in millions):

	Assume Corporations' Earnings on the Debenture are	
Year	0%	10%
1	$(16.5)	$ 24.3
2	$(33.0)	$ 48.5
3	$(57.8)	$ 85.0
4	$(82.5)	$121.4
5	$(123.8)	$182.1

The revenue impact in the fifth year if the size limit was reduced to $5 million in assets would be $(65.2) million and $61.9 million respectively.

The assumptions are based on IRS' 1976 Statistics of Income. When I have the 1980 Statistics I will update the figures. In addition the following assumptions are made:

1. The average SBPD will be $5,000 for companies with less than $100,000 in assets, 15% of assets for companies with $5,000,000 to $10,000,000 in assets and 10% of assets for all other corporations.

2. The profit sharing portion will be 5% of the face amount for the holder of the SBPD.

3. Number of corporations using the SBPD will rise from 2% in the first year to 15% in the fifth year.

4. The revenue in the first example is the 30% difference between maximum ordinary tax rate of 50% and maximum capital gains rate of 20%.

5. The revenue gain in the last example is the tax on a 10% earnings by corporations on the face of the SBPD less assumption 4.

The attached worksheet shows year 5 with these assumptions.

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YEAR 5 REVENUE LOSS ESTIMATES FOR THE SMALL BUSINESS PARTICIPATING DEBENTURE (SBPD)
DOLLAR AMOUNTS ARE IN THOUSANDS UNLESS STATED

SIZE OF SHARE	AVER SIZE(1)	NUMBER OF CORPORATIONS	CORPORATIONS TO USE SBPD PERCENT	CORPORATIONS TO USE SBPD NUMBER	AVER FACE OF SBPD(2)	TOTAL FACE OF SBPD	PROFIT SHARE(3)	TAX IMPACT OF THE PROFIT SHARE C.G.(4)	TAX IMPACT OF THE PROFIT SHARE ORDINARY(5)	TAX IMPACT OF THE PROFIT SHARE DIFFERENCE	TAX FROM EARNINGS(7)	REVENUE GAIN(8)
<$100	$39	601,151	15%	90,173	$5	$450,863	$22,543	$4,509	$11,272	$6,763	$6,763	$0
<$500	$234	435,314	15%	65,297	$23	$1,328,370	$74,498	$15,202	$38,204	$22,923	$27,507	$4,585
<$1,000	$700	101,338	15%	15,201	$70	$1,064,457	$53,223	$10,645	$26,611	$15,967	$31,934	$15,967
<$5,000	$1,028	86,501	15%	12,975	$103	$1,334,080	$66,704	$13,341	$33,352	$20,011	$41,360	$41,357
<$10,000	$13,652	12,617	15%	1,893	$2,048	$3,875,622	$193,781	$38,756	$96,891	$58,134	$178,279	$120,144
TOTAL	$370	1,236,921	15%	185,538	$44	$8,253,206	$412,660	$82,532	$206,330	$123,798	$285,856	$182,052

1. AVERAGE ASSET SIZE AND NET INCOME IS CALCULATED FROM IRS STATISTICS FOR 1976 FOR CORPORATIONS WITH NET INCOME

CATEGORY	TOTAL NO. CORPS	TOTAL ASSETS*	AVER. ASSETS	TOTAL NET INC.*	AVER NET INC.	TAX BRACKET	NET AS % OF ASSETS
<$100	601,151	$25,574	$37	$4,270	$7	15%	16%
<$500	435,314	$101,870	$234	$10,937	$25	10%	11%
<$1,000	101,338	$70,964	$700	$6,770	$67	20%	10%
<$5,000	86,501	$88,939	$1,028	$14,850	$195	46%	17%
<$10,000	12,617	$172,250	$13,652	$7,125	$565	46%	4%
TOTAL	1,236,921	$457,605	$370	$45,937	$37	18%	10%
FOR<$5,000	1,224,304	$295,355	$233	$38,012	$32	18%	14%

*THESE AMOUNTS ARE IN MILLIONS

2. AVERAGE SBPD IS ASSUMED TO BE $5,000 FOR FIRST CATEGORY
10% OF ASSETS FOR NEXT THREE CATEGORIES
15% OF ASSETS FOR LAST CATEGORY

3. PROFIT PARTICIPATION IS ASSUMED TO BE 5% OF FACE AMOUNT OF DEBENTURE

4. PERCENT OF CORPORATIONS USING THE SBPS WILL BE
IN FIRST YEAR 2%
SECOND YEAR 4%
THIRD YEAR 7%
FOURTH YEAR 10%
FIFTH YEAR 15%

5. SBPD TAX IS ASSUMED TO BE DUE AT THE MAXIMUM CAPITAL GAIN RATE OF 20%

6. NORMAL TAX IS ASSUMED AT 50%

7. CORPORATIONS EARN 10% OF FACE OF DEBENTURE TAXED AT BRACKETS USED IN ASSUMPTION 1

8) REVENUE (LOSS) OR GAIN IS DIFFERENCE OF TWO PRECEDING COLUMNS

Prepared by Edward H. Pendergast

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PROFESSIONAL EXPERIENCE

Consulting. President and Founder of Financial Management and Consulting Corporation since 1979. The company serves as financial advisor to growth oriented businesses.

Small Business. Elected President of the Smaller Business Association of New England (SBANE) in 1972 after serving in a variety of roles advocating the needs of small business. Served on Secretary of the Treasury's Small Business Advisory Committee as Chairman of the Tax Policy Subcommittee. Currently serving as Vice-Chairman of the Small Business Foundation of America, Inc. and Chairman, Massachusetts Governor's Small Business Advisory Council.

Public Accounting. Founded CPA firm of Pendergast, Creelman and Hill. Merged with the international CPA firm of Hurdman and Crantoun becoming partner-in-charge of the Boston and Maine offices. Appointed National Director of Planning. National responsibilities included mergers, acquisitions and marketing. Withdrew in 1979 to form Financial Management and Consulting Corporation.

Education. Develops and teaches courses in problems of closely-held family business and financing and tax planning for the small business.

Arbitrator. American Arbitration Association - Member of Commercial Panel.

PROFESSIONAL ASSOCIATIONS

Smaller Business Association of New England - President 1972-1973, Member of the Board of Directors 1978-1981, currently member of taxation committee.
Massachusetts Society of Certified Public Accountants - President 1977-1978, currently member of legislature and small business committees.
American Institute of Certified Public Accountants - Currently member of Small Business Committee and Past Member of Governing Council.
American Association of Accountants

EDUCATION

Bachelor of Science in Accounting, Bentley College
Master of Science in Taxation, Bentley College
Certificate of Advanced Graduate Study, Northeastern University Graduate School of Business Administration

July 11, 1983

WHAT CAN BE DONE?

Despite the difficulties before us, small business ... and Small Business United ... remain characteristically optimistic.

WE CAN TURN THE SITUATION AROUND. WE CAN MEND THE TATTERED FABRIC OF OUR NATIONAL ECONOMY AND REGAIN OUR TRADITIONAL POSITION IN WORLD TRADE. WE CAN AGAIN BECOME THE ENVY AND MODEL FOR THE WORLD'S DEVELOPING COUNTRIES. WE CAN MAKE "MADE IN AMERICA" THE EPITOME OF QUALITY, PRODUCTIVITY AND CREATIVITY IT ONCE WAS ... AND WE INTEND TO DO JUST THAT.

But in this effort to help ourselves and the Country, WE NEED COOPERATION FROM OUR ELECTED AND APPOINTED OFFICIALS IN WASHINGTON AND THE CAREER CIVIL SERVANTS WHO MAKE THINGS HAPPEN IN THE LONG RUN. Small Business doesn't live or operate in a vacuum. There are areas where Government can make a real difference on how fast and how effectively we can get things turned around.

SMALL BUSINESS PLEDGES TO DO ITS SHARE. WE ARE ASKING CONGRESS AND OTHER FEDERAL OFFICIALS TO MATCH OUR PLEDGE AND MAKE A SERIOUS COMMITMENT TO ASSIST US.

To help focus this effort, WE HAVE COME TO YOU WITH OUR PRIORITY ISSUES for your consideration and action. These aren't vague ideas, impractical solutions or unrealistic notions. They are specific recommendations to help us get the U.S. economy moving again.

Work with us to achieve these goals ... we can promise you hard work, cooperation and appreciation from the Nation's greatest source of pride ... its small business owners, managers and employees.

PRIORITY RECOMMENDATIONS SUMMARY

PRIORITY NUMBER ONE

Stimulate job creation and business investment by providing small business with greater access to capital for expansion. How? ...

- **Enact Small Business Participating Debentures (SBPD)**
  This is an outstanding idea whose time has come. Let's stop delaying this valuable tool's implementation and unleash this important source of capital to small businesses around the country!
- **Repeal Treasury Rule Concerning Debt/Equity Definition (TR-385)**
  This misguided and pernicious ruling, if allowed to take force, will undermine the entire relationship between industry and the financial community. It must be stopped ... now!
- **Preserve Industrial Revenue Bonds**
  These most valuable sources of capital at reasonable costs have proven to be a most effective stimulus. Last year's tax legislation corrected most of the abuses. IRB's must not be sacrificed on the short-term, myopic altar of budget cutting!
- **Institute a Capital Gains Tax Reform**
  Infusion of capital into growing small companies is essential. Capital gains tax reforms would create a stimulus for investors to invest and reinvest in small firms. The jobs created and revenue generated would far outweigh any short-term revenue impact.
- **Reinstitute a General Jobs Tax Credit**
  Putting someone to work has double impact. It reduces government support expenditures and creates a taxpayer. Since small business is labor intensive, a jobs tax credit would have an impact similar to accelerated cost recovery on plant and equipment in large companies.

PRIORITY NUMBER TWO

Provide small business with better access to new market opportunities. How? ...

- **Reemphasize and enforce OMB Circular A-76 (Contracting Out)**
  For fifteen years this specific policy of the government — not to compete with the private sector for commercial services and products — has been largely ignored. It's time that A-76 was enforced and that provisions are made to ensure that small business obtains its fair share of the work.
- **Expand Small Business Programs at EXIM Bank**
  Many U.S. small companies are in world markets, whether they know it or not. The nation must stimulate this untapped resource to compete internationally. EXIM Bank could be a vital contributor to this effort; but its programs must be better tailored to small business.

from Small Business United Washington Presentation - May 3 & 4, 1983

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PRIORITY NUMBER THREE

Enhance small business representation in federal government policy-making bodies. How? . . .

- **Maintain Strong Legislative Oversight**
  In the past two Congresses a number of important laws were passed to help small business and the nation. But these laws mean nothing if they are not monitored for compliance. Congress must make maximum use of its oversight power to ensure conformance to these statutes.
- **Mandate Small Business Representation on the Federal Reserve Board**
  The "Fed" is a vital cog in the monetary policy of the country. As such, its policies and rulings affect all sectors of the economy. Isn't it about time that the 12 million small businesses in the country had some first-hand representation on the Board and in the district banks?
- **Strengthen the Impact of the Small Business Administration**
  In the past five years, the SBA has developed better and better rapport with the small business community. Now it must begin to have more say in the councils of government. When economic policy is being decided, the SBA is the small business voice and must be included in the deliberations.
- **Establish Small Business Advisory Councils**
  Each Senator and Congressman should form a council of small business owners/operators from his/her district to promote dialogue on important and timely issues.
- **Mandate a New National Conference on Small Business**
  Because of small business' diversity, it is difficult to get nationwide participation in every ongoing issue. But a National Conference, convened under the auspices of the White House, will have the power to draw participants from all corners of the country and stimulate greater progress on small business issues.
- **Encourage Administrative Initiatives**
  The Congress can play an important role in urging and encouraging the Executive Branch to take action which would heighten small business' visibility in important councils/committees. SBU suggests several that would be great steps forward.

PRIORITY NUMBER FOUR

Enact a Uniform, Federal Liability Tort Reform

Product liability laws and standards have proliferated throughout the United States on a state-by-state basis. The result is a patchwork of differing statutes, some of which directly conflict. For companies, large and small, in multi-state markets, this unmanageable situation has caused a severe penalty due to costly insurance and litigation and has stifled technological advances due to the attendant complications in liability.

The difficulties, uncertainties and costs arising from this dilemma have placed disproportionate burdens on smaller firms who have been traditionally less able to cope with these matters due to limited resources.

THE SOLUTION IS THE ENACTMENT OF A FEDERAL PRODUCT LIABILITY TORT REFORM ACT WHICH WOULD SUPERSEDE STATE LAWS AND IMPOSE A UNIFORM STANDARD FOR THIS AREA NATIONWIDE.

SBU urges the passage of such a bill and supports S.44 as the best submittal yet encountered addressing this issue.

PRIORITY NUMBER FIVE

Enact Social Security Reform

This massive and basically highly successful Program has developed severe financing problems due to legislative adjustments and demographic changes over the years. Reform is needed; but reform measures must be fashioned in a way that fairly distributes the burden on all parties involved.

Since the vast majority of Social Security participants work for small businesses, small business has a major stake in this issue. SBU urges Congress to focus its attention on reforms that will insure the long-term viability of the system through initiatives such as:

- A raised retirement age, gradually phased-in
- Restructuring current cost-of-living adjustment indexing, perhaps to growth of real wages rather than the CPI
- Universal coverage
- Incentives for late retirement and disincentives for early retirement
- Removal of Social Security from the unified budget
- Independence of the Social Security Administration within the government.

from Small Business United Washington Presentation - May 3 & 4, 1983

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ADDITIONAL ISSUES THAT MUST BE ADDRESSED IN THIS CONFERENCE

The proposals outlined below are among those deemed most important by Small Business United to create a climate that will allow unrestrained growth of smaller enterprises. These proposals cover a variety of concerns — capital formation and retention, taxation, regulatory policy, export policy, government procurement and general small business policy development.

The issues are not listed in any particular order of priority, but are presented to indicate to the Congress and the Administration those issues Small Business United feels must be addressed in the immediate future.

Small Business United stands ready to provide testimony regarding these proposals at the appropriate time.

1. **Graduated Corporate Income Tax** — Expand the graduated brackets and reduce the rates within each bracket with the highest tax rate not beginning until the $500,000 level.

2. **Used Equipment Investment Tax Credit** — Increase the used equipment investment tax credit ceiling to $500,000.

3. **Direct Expensing** — Increase the amount of assets eligible for direct expensing to $25,000 per annum.

4. **Minimum Accumulated Earnings Credit** — Increase the level of permissible accumulated earnings to at least $500,000.

5. **LIFO Simplification** — Simplify the complex and costly last in-first out (LIFO) accounting method for inventories.

6. **New Start-up Businesses** — Eliminate taxes on the first $25,000 of profit of a new small business.

7. **Independent Contractors** — Maintain current status of independent contractors and oppose legislation making them company employees.

8. **Completed Contract Method of Accounting** — Support a size standard allowing small concerns to continue using the completed contract method of accounting.

9. **Small Business Investment Companies (SBICs)** — Support efforts to strengthen the SBIC venture capital financing program which returns $110 in tax revenues for every dollar invested by the federal government.

10. **Banking Reform** — Preserve and strengthen the competitive environment among our nation's banks and thrift institutions. Oppose regulatory changes and legislation which would induce greater concentration of the financial resources of our country.

11. **ERISA** — Pension fund plan asset definition should be amended to make more funds available for the small business sector.

12. **Multi-Employer Pension Plans** — Support bills to exempt certain multi-employer pension plans from withdrawal and termination liabilities by treating them as defined contribution plans.

13. **Patent Law** — Oppose proposals which undermine the statutory (P.L. 96-517) incentive given smaller companies to commercially market products and processes discovered with federal funds.

14. **Freedom of Information Act Reform** — Support for business provisions of bills which give greater protection to trade secrets and clarify ambiguities in the Act.

15. **Federal Records Maintenance** — Support efforts to reduce federal paperwork requirements and efforts to reduce the period for which records must be retained.

16. **Hobbs Act** — Amend the Act to make the use or threat of violence in labor disputes a criminal act.

17. **Davis-Bacon Act** — Repeal by phasing out the Act over five years.

18. **Domestic International Sales Corporations (DISC)** — Develop an alternative to DISC and put in place before DISC cancellation.

19. **Foreign Corrupt Practices Act** — Support legislation to clarify the ambiguities in the Act which work to preclude small business concerns from exporting.

20. **Antitrust Policy Affecting Exports** — Support Bills establishing a Presidential Commission to study the extra-territorial impact of U.S. antitrust laws.

21. **Progress Payments** — Support legislation requiring contract officers to waive retainage for those small business who post an adequate performance bond.

22. **Uniform Federal Procurement System** — Seek Congressional action to simplify, improve, and make uniform the federal procurement process as it relates to the small business sector.

23. **Small Business Data Base** — Require SBA to regularly report on twelve economic indices affecting small business as mandated in Title IV of P.L. 96-302.

Mr. PENDERGAST. I would like to just give some overviews and try not to be redundant with what the other speakers have said prior to this.

My name is Edward Pendergast. I am a financial consultant working with small business exclusively. I first became an activist in small business back in the sixty's and have been president of the Smaller Business Association of New England. Most recently I have been on the SBA Committee on Capital Access. I am currently the chief volunteer of a foundation called the Small Business Foundation of America. We are currently funding a study by David Birch at MIT on job generation in the high technology industry. Two of the cofunders are the National Venture Capital Association and the American Stock Exchange.

One of our early projects was the University of Chicago study on industrial revenue bonds which gave some ammunition to you and others to keep what we could keep in the industrial revenue bond.

Senator D'AMATO. Remember the caveat: Speak to the Speaker.

Mr. PENDERGAST. I am one of his constituents, and it perhaps would be best if I remain mute or at least control myself a little bit, because I have trouble getting the Speaker to be responsive to what I think is important to small business. So I will go on to——

Senator D'AMATO. Then send those associates and friends of yours in the district who he is favorably disposed to for making those points. Because I think Massachusetts probably has benefited as much as anyone.

Mr. PENDERGAST. Absolutely. There is no question about it.

Senator D'AMATO. It uses these various techniques, IDB's, etc.

Mr. PENDERGAST. I also serve as chairman of Governor Dukakis' Small Business Advisory Committee, and that legislation in Massachusetts was initiated—MIFA, the Massachusetts Industrial Finance Authority, was set up by him and has been one of the most successful in the country.

I will try to see if I can find some friends of his in small business.

I might just make some specific points about 1043, your bill, that weren't mentioned. In the rollover provisions I would like to see an addition that would allow the proceeds to be reinvested, not necessarily only in a small business but as well in an institution that specializes in small business investment, for instance, a venture capital organization. Frequently an older person has sold their interest in a small business. If that person could reinvest those proceeds and distribute the risk a little bit rather than get involved on one startup or something where they would have to maintain continual management contact, I think there would be an incentive for them to keep that money in the small business community.

The small business participating debenture, I think the $10 million equity limit is a little high. I think $5 million ought to be adequate to start out with.

I'm sorry that Senator Sasser is not still here, because in his discussions with Chairman Volker, one of the things I talked about in my testimony is the interest rate differentiation that small business pays. It is usually at least 2½ percent more than big business pays. If there is a 12-percent prime, that means that small business is paying 20 percent more for its debt than large business is paying.

Senator D'AMATO. Well, I am going to meet with him at 5:45, so I will bring it up.

Mr. PENDERGAST. Well, I hope one of the things you might ask him, then, Senator, is for an analysis to see if there is a justification for charging more interest for small business. I have very serious doubts, and I have had a lot of conversations with bankers who are running small business departments. They are extremely——

Senator D'AMATO. Would you give them the prime rate? You mean we give the prime rate to the large industrial complex and then the small business guy comes in and he gets 2 points over?

Mr. PENDERGAST. Yes, but the point that you miss is that the large company very rarely pays prime.

Senator D'AMATO. Pardon me?

Mr. PENDERGAST. The large company very rarely pays prime.

Senator D'AMATO. You mean he pays just a point over the discount?

Mr. PENDERGAST. In a Federal reserve analysis—I think it was in August of 1982 were the figures—85 percent of large loans were being made below prime. The small business was paying two to two and a half points above prime as a matter of routine, with compensating balance requirements as offsets.

Senator D'AMATO. Mr. Pendergast, when did you receive that information?

Mr. PENDERGAST. In August of 1982.

Senator D'AMATO. Do you share a similar view?

Mr. GREGORY. I certainly do. I think it is always put forward by the bankers that the risk is greater, and it is, but for some reason with the focus and the motivation of small businesses, their record is awfully good on an overall basis. I am sure there are some problems, but I think it is overused by the banking industry.

Mr. PENDERGAST. Yes, I think the risk argument is a lot of baloney. The loss ratio shown in the small business lending departments of banks is very comparable to the large section, particularly if you take in major failures, which you won't get in the small business community; you don't get an equity funding or you don't get hundreds of millions of dollars going down on one investment. And small business generates more demand deposits, which is a function of the cost. And they become the major future borrowers.

Interstate banking is a real threat or opportunity—I am not sure which at this moment—to this whole thing. The advantage of interstate banking is that the large banks will be able to organize and specialize small business lending departments. And we'll be able to get some statistics to make them prove that the losses and the risks are there.

Kind of the last area, I have seen the revenue estimates that Secretary Chapoton has come up with on your three bills, and——

Senator D'AMATO. You mean you just saw it now?

Mr. PENDERGAST. Yes. And I have to tell you——

Senator D'AMATO. You have better access than I do, because we just got it this morning.

Mr. PENDERGAST. Well, I just got it after that. But I have to tell you——

Senator D'AMATO. I thought maybe you had a mole in his office.

Mr. PENDERGAST. I have tried for a long time. I can remember coming out of there one day with a group of people, and somebody said, "I feel like I am back in the days of Roosevelt." But he meant Teddy. [Laughter.]

I am outraged by Secretary Chapoton's—what I would call an offhand dismissal of all phases of the bills. The outrageous revenue estimates. And if I were in a position in the U.S. Senate I would charge the Secretary of Treasury to show how they have calculated their revenue estimates. The last time they came up with revenue estimates on the small business participating debenture, all we saw was one page. Behind that, Bobby Shapiro, who was then responsible for that phase, had shown that if you took a dynamic analysis in fact there was a significant decrease in the amounts. But that wasn't mentioned in the cover letter. All he took was the most absolutely worst assumptions you could make, that we would completely replace all other borrowings with small business participating debentures.

Senator D'AMATO. Maybe we will enlist you to pursue that with some of our staff here.

Mr. PENDERGAST. Well, if you think I can get to the Secretary of the Treasury better than you can or—well, I think both of us have trouble.

Senator D'AMATO. I haven't had that much success myself.

Mr. PENDERGAST. I will say one thing, sir, if I may summarize. The end of my suggestion was that part of the solution to this, I think, is mandating small business representation in significant departments in the Federal Government. When Secretary Simon was Secretary of the Treasury, he set up a Small Business Advisory Committee. And I can't tell you that we were a lot more pleased with the outcome, but I can tell you that Treasury gave a lot more considerations to their pronouncements, having to respond to Simon—he would sit down at the advisory committees himself and listen to the objections. And the staff people really hustled. We haven't had anything like that since.

I think that type of representation would bring significant changes in the attitude of Treasury and other sections of the Government. I think we have seen it in the SBA. They are much more responsive since the original legislation, which was sponsored by Margaret Heckler at our request to set up the SBA advocacy.

Well, what I think small business needs is to get rid of the discrimination against it, and just have fair, well-balanced legislation.

I thank you for your help in leading that charge.

Senator D'AMATO. Well, thank you, Mr. Gregory and Mr. Pendergast.

Thank you for your thoughtful presentations. I am not going to go over ground that has been covered, because it is obvious that you see the need and have testified to the need for adopting and bringing about the kind of legislation that will encourage real capital formation and participation and real growth. I thought we were for real growth, you know, I really did. I won't tell you how my political philosophy came to make me a Republican, but I always thought we were going to go out there and encourage people—upward mobility and whatnot. Sometimes I wonder where we are at.

I'm a guy who went out and campaigned against spending $17,000 a year for someone on a training program who got no training and wound up only getting $7,000, but the program cost $17,000, and ended up at the end of 18 months getting thrown out. I still believe that. And I believe that if we are going to be successful in getting the rest of America to believe that we had better begin to create the kind of climate that will be conducive for the business community to go out and produce and to be successful competitors in a worldwide marketplace.

I would be interested in getting some of the facts with respect to what, for example, do the Japanese tax their business people at, corporations and small business. What kinds of tax advantages have they got built into the system. If we are talking about competition that might be noteworthy.

Before we end this hearing, the record will be kept open for an additional 2 weeks so that some of the Senators including myself will be able to submit additional testimony, and any other interested parties. We will continue to receive testimony.

I thank all those who have participated.

This hearing comes to an end.

[Whereupon, at 12:33 p.m., the hearing was recessed, to reconvene at the call of the Chair.]

[Subsequent information was received and follows:]

FINANCIAL
MANAGEMENT&
CONSULTING
CORPORATION

August 18, 1983

Mr. Michael Haynes
Chief Council
Senate Small Business Committee
SR 428A
Washington, D.C. 20510

Dear Mike:

Enclosed is an update of my revenue estimates and an attachment to my Senate Small Business Committe testimony.

You should note I use asset size rather than equity because that is the only strata that the IRS uses. I have tried to address this by increasing the asset size to $25 million. The average equity size of the 5,956 corporations in the $25 million to $50 million asset size corporation is $9.3 million. The fifth year revenue estimates show a revenue loss of $179.1 million if the corporations earn zero from their use of the SBPD and a revenue gain of $219.2 million if the corporations earn 4.1%. If the corporation earns on the debenture at their average return as shown on assumption 1, the revenue gain is $145.4 million.

If you use only up to $5 million asset size, the fifth year revenue loss is $113.4 million if the corporations earn zero from the use of the SBPD and a revenue gain of $142.1 million if the corporations earn only 10%. The revenue break even comes when the corporations earn 4.5%. If the net is their average taxable income as shown in assumption 1, the revenue gain is $96.4 million.

Sincerely,

Ed

Edward H. Pendergast

EHP:lml
Enclosures

One Faneuil Hall Marketplace
Boston, Massachusetts 02109
Telephone: (617) 720-0400

Attachment to Testimony of Edward H. Pendergast as Requested

Revenue Impact of the Small Business Participating Debenture

The estimated revenue gains or (loss) for each of the first 5 years is as follows ($ in millions):

Year	Assume Corporation's Earnings on the Debenture *	
	0%	10%
1	$(23.9)	$ 29.2
2	$(47.7)	$ 58.4
3	$(83.6)	$102.3
4	$(119.4)	$146.1
5	$(179.1)	$219.2

*After payment of a profit participation to the debenture holder of 5% of the face of the debenture.

The revenue impact in the fifth year if the size limit was reduced to $5 million in assets would be $(65.2) million and $61.9 million respectively.

The assumptions are based on IRS' 1980 Statistics of Income. In addition the following assumptions are made:

1. The average SBPD will be $5,000 for companies with less than $100,000 in assets, the $1,000,000 maximum for companies with $5,000,000 to $25,000,000 in assets and 10% of assets for all other corporations.

2. The profit sharing portion will be 5% of the face amount for the holder of the SBPD.

3. Number of corporations using the SBPD will rise from 2% in the first year to 15% in the fifth year.

4. The revenue in the first column above is the 30% difference between maximum ordinary tax rate of 50% and maximum capital gains rate of 20%.

5. The revenue gain the in the second column is the tax on a 10% earnings by corporations on the face of the SBPD less assumption 4.

The attached worksheet shows year 5 with these assumptions.

Revenue break even is achieved in year 5 when assumption 5 earnings are as low as 4.1%. At the corporation's average net on assets from the table, the revenue gain is $145.4 million.

YEAR 5 REVENUE LOSS ESTIMATES FOR THE SMALL BUSINESS PARTICIPATING DEBENTURE (SBPD) SBPD1
DOLLAR AMOUNTS ARE IN THOUSANDS UNLESS STATED
prepared by E.H.Pendergast as of August 15,1983

SIZE RANGE	AVER SIZE(1)	NUMBER OF CORPORATIONS	CORPORATIONS TO USE PERCENT	CORPORATIONS TO USE NUMBER	AVER FACE OF SBPD(2	TOTAL FACE OF SBPD	PROFIT SHARE(3	TAX IMPACT OF THE PROFIT SHARE C.G.(5	TAX IMPACT OF THE PROFIT SHARE ORDINARY(6	TAX IMPACT OF THE PROFIT SHARE DIFFERENCE	TAX FROM EARNINGS(7	REVENUE GAIN(8
<$100	$38	738,711	15%	110,807	$5	$554,033	$27,702	$5,540	$13,851	$8,310	$8,310	$0
<$500	$235	526,953	15%	79,043	$24	$1,858,621	$92,931	$18,586	$46,466	$27,879	$33,455	$5,576
<$1,000	$697	137,827	15%	20,674	$70	$1,440,765	$72,038	$14,408	$36,019	$21,611	$43,223	$21,611
<$5,000	$2,019	122,405	15%	18,361	$202	$3,707,850	$185,393	$37,079	$92,696	$55,618	$170,561	$114,943
<$10,000	$7,005	16,568	15%	2,485	$1,000	$2,485,200	$124,260	$24,852	$62,130	$37,278	$114,319	$77,041
<$25,000	$15,857	12,605	15%	1,891	$1,000	$1,890,750	$94,538	$18,908	$47,269	$28,361	$86,975	$58,613
TOTAL	$522	1,555,069	15%	233,260	$51	$11,937,219	$596,861	$119,372	$298,430	$179,058	$456,843	$279,172

1. AVERAGE ASSET SIZE AND NET INCOME IS CALCULATED FROM IRS STATISTICS FOR 1980 FOR CORPORATIONS WITH NET INCOME

CATEGORY	TOTAL NO. CORPS	TOTAL ASSETS*	TOTAL EQUITY*	AVERAGE EQUITY	AVER. ASSETS	TOTAL NET INC.*	AVER INC.	TAX BRACKET	NET AS % OF ASSETS
<$100	738,711	$28,079	$11,581	$16	$38	$3,470	$5	15%	12%
<$500	526,953	$123,980	$56,782	$108	$235	$11,388	$22	18%	9%
<$1,000	137,827	$96,051	$40,687	$295	$697	$7,492	$54	30%	8%
<$5,000	122,405	$247,190	$98,244	$803	$2,019	$19,585	$160	46%	8%
<$10,000	16,568	$116,061	$43,861	$2,647	$7,005	$8,757	$529	46%	8%
<$25,000	12,605	$199,878	$62,201	$4,935	$15,857	$10,949	$869	46%	5%
TOTAL	1,555,069	$811,168	$313,356	$202	$522	$61,641	$40	19%	8%
FOR<$5,000	1,325,896	$495,229	$207,294	$136	$325	$41,933	$27	19%	8%

*THESE AMOUNTS ARE IN MILLIONS

2. AVERAGE SBPD IS ASSUMED TO BE $5,000 FOR FIRST CATEGORY
10% OF ASSETS FOR NEXT THREE CATEGORIES
15% OF ASSETS FOR LAST THREE CATEGORIES UP TO THE $1,000,000 MAXIMUM
3. PROFIT PARTICIPATION IS ASSUMED TO BE 5% OF FACE AMOUNT ON DEBENTURE
4. PERCENT OF CORPORATIONS USING THE SBPD WILL BE
IN FIRST YEAR 2%
SECOND YEAR 4%
THIRD YEAR 7%
FOURTH YEAR 10%
FIFTH YEAR 15%
5. SBPD TAX IS ASSUMED TO BE DUE AT THE MAXIMUM CAPITAL GAIN RATE OF 20%
6. NORMAL TAX IS ASSUMED AT 30%
7. CORPORATIONS EARN 10%OF FACE OF DEBENTURE TAXED AT BRACKETS USED IN ASSUMPTION 1
8. REVENUE (LOSS) OR GAIN IS DIFFERENCE OF TWO PRECEDING COLUMNS

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